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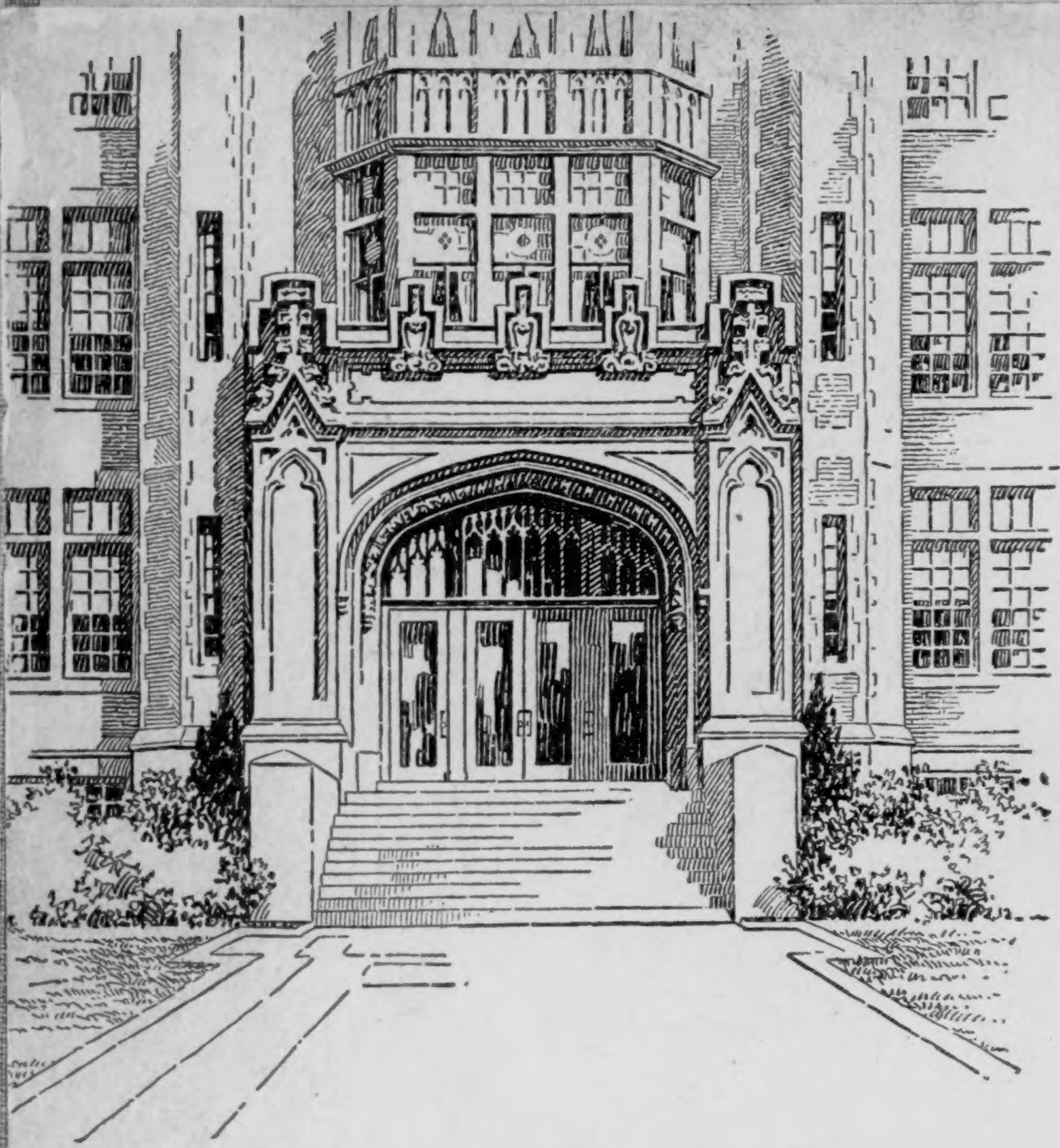

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Scranton, Pa.

Accounting for Branches, Combinations, and Reorganizations

PREPARED ESPECIALLY FOR HOME STUDY

By
SIDNEY G. WINTER, C. P. A.
HEAD OF DIVISION OF ACCOUNTING
COLLEGE OF COMMERCE, UNIVERSITY OF IOWA

2818 EDITION 1

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for
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INSTRUCTIONS FOR STUDENTS

The section on Accounting for Branches, Combinations and Reorganizations contains four lessons, each consisting of one or two chapters, as shown in the Outline of Lessons on the preceding page. On reading the text you will find that at the end of each chapter questions or problems or both are given to which answers or solutions are to be prepared by you. Your work is to be retained until all the chapters contained in a lesson have been read and answers and solutions to the questions and problems at the end of each have been prepared. Then, inspect your work carefully and send answers and solutions for examination. Continue with the study of the next lesson. The completion of this text requires the mailing of four sets of answers.

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ACCOUNTING FOR BRANCHES, COMBINATIONS AND REORGANIZATIONS

CHAPTER I

AGENCIES AND BRANCHES

1. Reasons for Establishing Agencies and Branches.—In marketing goods over a wide territory, the manufacturer or large distributor of a particular line of merchandise is faced with the serious problem of determining some means by which the company may maintain a reasonable degree of contact with its customers. This is particularly true when a nationally advertised brand is handled. It is essential that the distant customer receive satisfactory service, that his orders be handled promptly and courteously, that complaints be adjusted promptly and to the satisfaction of the customer, and that the product be favorably as well as widely known. The manufacturer or distributor, by carefully selecting jobbers and retailers may, in some measure, accomplish the desired end. Certain of his outlets may be very satisfactory, while others are less so, because there is no uniform managerial policy governing each and every outlet. The system of agencies or branches has been adopted by many manufacturers and distributors in order to secure more strict control over the retail distribution of products.

2. Agencies.—If the agency system is followed, the agents are carefully selected throughout the territory to be served. Ordinarily they are supplied with samples and with catalogs or other descriptive literature. The agent in some cases may carry in stock a number of repair parts if such are essential to the satisfactory merchandising of the main product. In dealing with customers, the agent ordinarily takes orders for their requirements. These are forwarded to the main office or to a branch distributing point, from which place they are filled, the goods being sent either to the agent or directly to the customers. The head office passes on all requests for credit and likewise undertakes to make collections. Some memorandum is usually kept of the transactions with each agent, this memorandum serving the dual purpose of a basis for commissions and a record of the business transacted in a given territory. All agencies are not handled on exactly the same basis. In some instances, the agent may deliver goods to the customer from a very small stock which he keeps on hand. This practice is particularly adapted to those lines of merchandising in which the number of units from which a choice may be made is relatively small. Thus, in the case of typewriters, for example, the agent may dispose of a machine from his stock and immediately order a new one from the factory. In still other cases, the agent is expected to buy the samples that he keeps on hand. Usually, he has the privilege

of returning unsold units if the agency is surrendered. If the agent receives cash from a customer he remits this to the head office after deducting his commission. *Theoretically, the agency is solely an order-taking unit but, in practice, wide variations will be found from this principle.*

3. Branches.—Although the agent is the direct representative of his principal it is frequently found that agencies present the same difficulties that are found in connection with the independent retailing of the manufacturer's product. Even with strict supervision over all agencies, it is difficult to secure uniform results. For this and other reasons, many distributors and manufacturers have turned to the establishment of branch houses or branch retail stores. The chain-store system in groceries, meats, cigars, drugs, hardware, and other lines is based on this principle. A branch is a local unit of the parent or principal store. One branch is very likely to be quite similar to any other branch in the system. This is certainly the case with the five and ten cent stores. They differ principally in the matter of catering to strictly local needs. Each branch carries a stock of merchandise, usually passes on its own credits, makes it own collections, and, in general, attempts to be a local store. In some instances, credits may be supervised by the head office and, in some cases, collections are supervised from the same source. The degree of control over the branch desired by the head office varies between given lines of industry and between manufacturers or distributors of a given line of merchandise. The accounts kept are largely dictated by the degree of control desired.

The accounts vary, too, with the complexity of the operations of the branch. For example, the company may own the land and building connected with the branch. This may be true, likewise, of large amounts of fixed equipment. In such cases, the fixed assets may be carried on either the branch books or the head-office books. At times the head office may wish to have special control over merchandise sent to the branch. In such case, a special account with the shipments may be maintained, while other current transactions are passed through the branch control accounts. If no special merchandising problem exists and if the branch owns little or no fixed equipment, all branch transactions may be passed through one branch account on the books of the head office.

Head-Office Books

Cash.—Cash sent to the branch should be charged to Branch A Current Account, and credited to the Cash account. If this remittance is to reimburse a petty cash fund, it follows that the expense accounts of the branch are being carried on the head-office books. To establish a petty cash fund for the branch, the entry is no different from that establishing any other petty cash fund, except that it may be charged to either Petty Cash, Branch A, or Branch A Current Account. Subsequent reimbursements of the fund are handled in the usual manner.

For cash received from the branch, the head office should charge Cash account and credit Branch A Current Account.

Merchandise.—No special problem presents itself in connection with merchandise shipped to branches, unless the shipment is made at some figure other than cost price. If the shipment is made at cost, the amount may be charged to Branch A Current Account and credited to Purchases.

If shipments to branches are not made at cost price they will be made at either selling price or at some arbitrary figure. Goods may be shipped at selling price if the head office does not wish to have the branch manager know what gross margin exists on the various lines that he handles. He receives the goods at the price for which he is expected to sell them. Shipments may be made at a conventional or arbitrary price for much the same reason. This price makes it almost impossible for the branch manager to know exactly what gross margin is obtained. In either case, shipments should be recorded in memorandum accounts, as follows:

Branch A, Merchandise Shipments	\$xxxx	
Shipments to Branches		\$xxxx

Used in this manner, *memorandum accounts* are accounts that are designed to "call to mind" certain transactions. They reflect some but not all of the facts of the transactions recorded. Here, the shipments *have been made* but the amounts recorded are not those to be given effect in the final statements. Similar uses of memorandum accounts are frequently found in recording shipments from a consignor to a consignee.

A separate account must be kept for the shipments to each branch, but only one Shipments to Branches account need be maintained. These accounts must be adjusted at the end of the fiscal period in order to charge each branch with its purchases at cost price.

Returned merchandise is ordinarily handled by reversing the entry made when the goods were shipped. If it seems desirable to do so, special return accounts may be set up. These present no unusual features.

Branch Purchases.—In some organizations the branch manager is permitted to make purchases for his store from local dealers. This may be true, for example, of a chain grocery store in connection with fresh fruits and fresh vegetables. These present a very definite local problem, and the head office is seldom in position to know just which articles may be purchased at a given time to best advantage. In other lines, particularly clothing, the five and ten cent stores, and drug stores, for example, local purchases are likely to be wholly unnecessary. In those cases in which local purchasing seems desirable, no special accounting problem arises. The purchases are recorded on the branch books in a separate account from that used to record the receipt of merchandise from the head office. The offsetting credit is to Cash or to Accounts Payable. In some instances, the account must be forwarded to the head office for payment. If this procedure is followed, the head office charges Branch A Current Account and credits Cash.

Current Expenses.—Operating expenses may be paid at the branch or from the head office. If paid by the head office, there should be a debit to Branch A Current Account, with a corresponding credit to Cash. This assumes that the expenses of each branch will be kept separate from those of each other branch. This is

usually done currently, whether or not independent branch profit and loss statements are compiled at the end of the fiscal period. When no segregation of expense accounts by branches is desired, the charges may be made directly to the expense accounts involved, with a corresponding credit to Cash.

Fixed Equipment at Branches.—Fixed equipment at branches may be carried on either the head-office books or the branch books. In the former case, the assets are set up on the head-office books as acquired, with credits to Accounts Payable or to Cash. Depreciation on these assets is likewise carried on the head-office books. A memorandum may be sent to the branch at the end of each fiscal period for the current depreciation charge. If this is not done, the expense of depreciation must be added to the branch results after they are received at the head office. If fixed equipment is carried on the branch books, the head office is likely to carry these items under the account, Branch A—Fixed Equipment. There is then no necessity for the head office to carry detailed records of branch assets in its general ledger. Likewise, the fixed items are removed from the current or operating account kept with each branch.

Branch-Office Books

Cash.—The recording of cash transactions at the branch depends largely on the degree to which the branch is independent of the head office. In some instances, all receipts from cash sales and from collections of accounts receivable are deposited in a local bank *to the credit of the head office.* In such case, the branch ordinarily will have an imprest, or petty cash, fund for the payment of current expenses. This fund is replenished by remittances from the head office when expense vouchers are submitted by the branch office. In other cases, the branch office may have only a very small petty cash fund. Under this method, all expense vouchers are paid directly by the head office, after being submitted by the branch.

Not infrequently, however, the branch will handle its cash in a manner analogous to that obtaining in any independent local store. Deposits are made of all cash receipts, and disbursements are made by checks drawn by the branch manager. Periodically remittances of cash are made to the head office. These remittances should be charged to an account entitled Remittances to Head Office. This enables the branch manager to tell at a glance the amount that has been forwarded to the head office. One occasionally finds such remittances charged directly to the Head Office Current Account. When the remittance account is used, it must be closed to Head Office Current Account at the end of the period. Further comment on cash transactions is included in other items which follow.

Merchandise.—Comment has already been made on the method under which the branch office may be billed for merchandise shipped to it from the head office. If shipments are received at cost price, the branch should debit Merchandise from Head Office and credit Head Office Current Account.

If it is the policy of the head office to make shipments at either selling price or an arbitrary or conventional price, the branch should take up these shipments by an

entry debiting Merchandise from Head Office and crediting Head Office Merchandise Shipments. This entry serves primarily as a memorandum of the transaction. Its further disposition will be discussed in connection with closing the books.

Local Purchases.—As has been previously explained, no special problem arises in connection with purchases made locally by the manager of the branch. Care should be taken to preserve invoices or other adequate record of such transactions for purposes of audit.

Expenses.—Ordinary operating expenses are recorded by debiting the proper expense account and crediting Cash or Accounts Payable, if they are to be paid locally, or Head Office Current Account if payment is made directly from the head office. As is the case with any business enterprise, the number and type of accounts kept is governed entirely by the amount of information desired concerning the expenses of the branch. In some organizations, *the independence of the branch manager is very sharply restricted as soon as expenses other than ordinary operating expenses are involved.* For example, donations to local relief activities or to a community chest or to a city-beautifying scheme are likely to be made only after approval by the head office. This may be true also of the appropriation for advertising. In the case of a branch that is a part of a nationally advertised system, the head office is likely to plan practically all of the advertising for the local branch. This means that the manager is frequently unable to buy advertising space in programs, school or college publications, or similar advertising media. Recently many of the larger organizations have granted local managers much more discretion in this matter. This is in all probability a part of the national organization's attempt to reduce local prejudice against chain stores and to have each local branch regarded very much as a "home town undertaking."

Fixed Assets.—The acquisition of fixed assets by the branch presents no special problem if the assets are carried only on the head-office books. In such case, the branch manager may be wholly unaware of the amount of capital invested in the fixed equipment of his particular store. Occasionally fixed assets acquired locally by the branch manager are set up temporarily on the branch books. At the end of the current fiscal period these assets are charged back to the head office. Entries to record such transactions are similar to the following:

At time of acquisition:

Fixed Assets Acquired	$xxxx	
Cash		$xxxx

At end of fiscal period:

Head Office, Current Account	$xxxx	
Fixed Assets Acquired		$xxxx

On the head-office books, no entry would be made at the time the fixed asset is acquired. At the end of the fiscal period, when the branch transfers the asset, the head office records the transfer:

Branch A, Fixed Equipment	$xxxx	
Branch A, Current Account		$xxxx

When fixed assets are carried regularly on the branch-office books they are handled very much as though the branch were an independent organization. Assets acquired through the expenditure of branch funds are charged to the proper asset account and credits are made to Cash or to Accounts Payable. The following entry is also required:

Head Office, Current Account	$xxxx	
Head Office, Investment Account . . .		$xxxx

The corresponding entry in the head-office books is:

Branch A, Investment Account	$xxxx	
Branch A, Current Account		$xxxx

If a given fixed asset is received from the head office or paid for by the head office, its acquisition should be set up by a debit to the proper asset account and a corresponding credit to Head Office Investment Account. If, for some reason, the investment account is undesired, the credit may be to the Head Office Current Account. Obviously, the treatment of these items on the branch books should be analogous to that on the home office books.

4. Branch-House Operations.—The operations of a branch house may be indicated by the following illustrative cases:

Illustrative Case No. 1:

Illustrative entries, **T** accounts, and statements, are based on the following transactions and additional data:

1. Cash sent to branch, $800.
2. Merchandise sent to branch, cost $4,000.
3. Merchandise purchased locally on account by branch, $1,400.
4. Sales by branch: cash $4,000; on account $5,000.
5. Collections of accounts receivable, $4,300.
6. Cash sent to head office, $6,500.
7. Cash paid on accounts payable, $1,000.
8. Expenses of branch paid, $1,200.
9. Uncollectable accounts, estimated $150.
10. Inventory at branch, $1,050.

JOURNAL ENTRIES

(Note: Numbers at the left refer to the transactions.)

Head-Office Books			*Branch Books*		
1. Branch Current Account Cash	$ 800	$ 800	Cash . . . . H. O. Current Account .	$ 800	$ 800
2. Branch Current Account Purchases	4,000	4,000	Merchandise from H. O. . H. O. Current Account .	4,000	4,000
3.			Purchases . . . . Accounts Payable . .	1,400	1,400

JOURNAL ENTRIES—(Continued)

Head-Office Books			*Branch Books*		
4.			Cash . . . . Accounts Receivable . . Sales	4,000 5,000	9,000
5.			Cash. . . . . Accounts Receivable . .	4,300	4,300
6. Cash . . . . . . Branch Current Account	6,500	6,500	H.O. Current Account . Cash	6,500	6,500
7.			Accounts Payable . . . Cash	1,000	1,000
8.			Expenses (Classified) . . Cash	1,200	1,200
9.			Bad Debts . . . . . . Bad Debts Reserve . .	150	150
10.			Inventory . . . . . . Sales . . . . Purchases . . . . . Merchandise from H. O. . Profit and Loss . . .	1,050 9,000	 1,400 4,000 4,650
11.			Profit and Loss . . . . Bad Debts . . . . . Expenses	1,350	 150 1,200
12. Branch Current Account Branch Profit and Loss	3,300	3,300	Profit and Loss. . . . H. O. Current Account .	3,300	3,300

The result of posting the foregoing entries is shown by the following **T** accounts:

HEAD-OFFICE BOOKS

Branch Current

800 4,000 3,300	6,500

Cash

6,500	800

Purchases

	4,000

Branch Profit and Loss

	3,300

BRANCH BOOKS

Cash

800 4,000 4,300	6,500 1,000 1,200

Merchandise from H.O.

4,000	4,000

Purchases

1,400	1,400

Inventory	
1,050	

Accounts Receivable	
5,000	4,300

Bad Debts Reserve	
	150

H. O. Current	
6,500	800
	4,000
	3,300

Accounts Payable	
1,000	1,400

Sales	
9,000	9,000

Expenses	
1,200	1,200

Bad Debts	
150	150

Profit and Loss	
1,350	4,650
3,300	
4,650	4,650

Branch Balance Sheet
December 31, 19__

Cash		$ 400	Accounts Payable	$ 400
Accounts Receivable	$700		H. O. Current Account	1,600
Reserve	150	550		
Inventory		1,050		
		$2,000		$2,000

Branch Profit and Loss Statement
Year Ended December 31, 19__

Sales		$9,000
Cost of Goods Sold:		
Purchases	$1,400	
Merchandise from H. O.	4,000	
Goods Available	$5,400	
Inventory	1,050	4,350
Gross Profit on Sales		$4,650
Less Expenses:		
Expenses (Classified)	$1,200	
Bad Debts	150	1,350
Net Profit for the Year		$3,300

The head office trial balance may be assumed to be as follows:

Head-Office Trial Balance

Cash	$ 4,000	
Accounts Receivable	18,000	
Reserve for Bad Debts		$ 320
Inventory	4,000	
Purchases	56,000	
Expenses (Classified)	10,000	
Bad Debts	480	
Sales		70,000
Branch Current Account		1,700*
Accounts Payable		5,000
Notes Payable		2,000
Capital Stock		10,000
Surplus		3,460
	$92,480	$92,480

*This is the balance before the branch profit is taken up.

Inventory of merchandise on hand, $6,000.

From the statements supplied by the branch and the head-office trial balance, combined statements may be prepared as in Illustration 1.

Statement of Profit and Loss
Year Ended December 31, 19__

	Head Office	Branch	Together
Sales	$70,000	$ 9,000	$79,000
Cost of Goods Sold:			
Inventory	$ 4,000		$ 4,000
Purchases	56,000	$ 5,400	61,400
Available	$60,000	$ 5,400	$65,400
Inventory	6,000	1,050	7,050
Cost of Goods Sold	$54,000	$ 4,350	$58,350
Gross Profit on Sales	$16,000	$ 4,650	$20,650
Less Expenses:			
Expenses (Classified)	$10,000	$1,200	$11,200
Bad Debts	480	150	630
Totals	$10,480	$ 1,350	$11,830
Net Profit for the Year	$ 5,520	$ 3,300	$ 8,820

Illustration 1

Prior to preparing a consolidated balance sheet as in Illustration 2 the head office should take up the branch profit or loss as indicated in entry 12 in the preceding journal entries. This brings the reciprocal accounts (Branch Current and Head Office Current Accounts) into agreement so that they may be eliminated.

BALANCE SHEET
December 31, 19__

	Head Office	Branch	Total
Assets:			
Cash	$ 4,000	$ 400	$ 4,400
Receivable (Net)	17,680	550	18,230
Inventory	6,000	1,050	7,050
Totals	$27,680	$ 2,000	$29,680
Liabilities:			
Notes Payable	$ 2,000		$ 2,000
Accounts Payable	5,000	$ 400	5,400
Totals	$ 7,000	$ 400	$ 7,400
Net Worth			22,280
Capital Stock		$10,000	
Surplus		12,280	

ILLUSTRATION 2

The balance sheet, Illustration 2, is prepared for the management and for others who may be closely connected with the company. For general purposes, the statement would appear in the usual form and present only the amounts shown above in the total column.

Illustrative Case No. 2:

Transactions:

1. Cash sent to branch, $800.
2. Merchandise sent to branch: cost, $5,200; selling price, $10,400.
3. Sales by branch for cash, $9,000.
4. Expenses of branch paid, $1,350.
5. Cash sent to head office, $7,500.
6. Inventory at branch, $1,400 at selling price.

JOURNAL ENTRIES
(NOTE: Numbers at the left refer to the transactions.)

	Head-Office Books			*Branch Books*		
1.	Branch Current Account	$ 800		Cash	$ 800	
	Cash		$ 800	H. O. Current Account		$ 800
2.	Branch Merchandise	10,400		Merchandise from H. O	10,400	
	Branch Shipments		10,400	H.O.Merchandise Shipment		10,400
3.	. . . .			Cash	9,000	
				Sales		9,000

JOURNAL ENTRIES—(Continued)

	Head-Office Books			*Branch Books*		
4.	. . . .			Expenses (Classified)	1,350	
				Cash		1,350
5.	Cash	7,500		H. O. Current Account	7,500	
	Branch Current Account		7,500	Cash		7,500
6.	Branch Shipments	10,400		Inventory	1,400	
	Branch Current Account	7,650		H.O. Merchandise Shipments	9,000	
	Branch Merchandise		9,000	Sales	9,000	
	Purchases		5,200	Merchandise from H. O.		10,400
	Reserve for Unrealized Profit in Inventory		550	Expenses (Classified)		1,350
	Branch Profit and Loss		3,300	H. O. Current Account		7,650

Comments:

(*a*) When merchandise is shipped to a branch *at other than cost price*, little is gained by showing a Profit and Loss account on the branch books. No profit and loss statement can be prepared until the actual cost of goods sold and inventory values are determined by the head office. Entry 6 on the branch books shows an apparent branch profit of $7,650. This figure, however, does not make allowance for the cost of goods sold and of inventory on hand. Entry 6 on the head-office books takes account of these facts and shows the true branch profit as $3,300.

(*b*) A detailed inventory of the merchandise on hand at the branch is sent to the head office. This inventory shows a sales value of $1,400. *On the average*, goods were marked up 100 per cent. on cost, when shipped. It does not follow, however, that this percentage applied alike to all articles, and, hence, it cannot be assumed that the cost price of the $1,400 inventory is $700. It is assumed that the inventory, repriced at cost by the head office, had a value of $850. Accordingly, a reserve is set up for the unrealized profit of $550 ($1,400—$850) in the branch inventory.

(*c*) Some accountants use the regular Branch Current Account and Head Office Current Account in lieu of the foregoing Branch Merchandise and Head Office Merchandise Shipments account, respectively, for merchandise shipments at other than cost price. If these accounts are used in entry No. 2 of this Illustrative Case, entry No. 6 must appear as follows:

Head-Office Books			*Branch Books*		
Branch Shipments	$10,400		Inventory	$1,400	
Purchases		$5,200	H. O. Current Account	1,350	
Reserve for Unrealized Profit in Inventory		550	Sales	9,000	
Branch Current Account		1,350	Expenses (Classified)		$1,350
Branch Profit and Loss		3,300	Merchandise from H. O.		10,400

The entry on the branch books shows an apparent branch loss of $1,350. This is due to the fact that the merchandise received from the head office was recorded at $10,400, not at $5,200, the cost price. The entry on the head-office books shows the branch profit to have been $3,300. Had all the merchandise received from the head office been sold, the gross profit would have been $10,400 − $5,200 = $5,200. From this amount must be set aside $550 to cover unrealized profit on goods still on hand at the branch. The branch expenses must also be deducted before the true branch profit is known.

(*d*) In preparing a consolidated balance sheet, four of the accounts mentioned receive the following treatment:

Branch Merchandise (Dr. on H. O. books) is eliminated against Head Office Merchandise Shipments (Cr. on Branch books).

Reserve for Unrealized Profit in Inventory (Cr. on H. O. books, $550) is deducted from Inventory (Dr. on Branch books, $1,400) to show inventory at cost price of $850.

Illustrative Case No. 3:

Transactions:

1. The Rite Company establishes its first branch, known as Branch A, by purchasing real estate (land $2,500 and building $5,000) and $2,000 worth of fixtures. Immediately prior to the opening of the branch, the head office forwards $500 in cash, $300 worth of advertising supplies, and merchandise billed at $5.190.
2. The head office determines its selling price to the branch by adding 20 per cent. to the cost price. The head office wishes to maintain three branch accounts, first the current account, second an account with merchandise, and third, an investment account. The fixed assets were acquired for cash.
3. Merchandise having a billed price of $15,120 is received by the branch from the head office.
4. Cash remittances to the head office amount to $15,000.
5. The branch makes sales of $30,000, $18,000 being for cash and $12,000 on account.
6. The branch makes purchases for cash locally. These amount to $4,200.
7. Cash amounting to $9,800 is received on account from customers.
8. The head office charges the branch $900 for advertising supplied to the branch.
9. The branch pays the following expenses in cash: Advertising expense, $660; Salaries and wages, $5,040; Light and heat, $480; Maintenance, $1,200.

10. A reserve for bad debts is set up in the amount of $230 on the branch books.
11. The books are closed at the end of six months of operation. Depreciation is determined on a straight-line basis, it being assumed that the fixtures have a service life of ten years and that the building should last twenty years.
12. Inventories on hand at the end of the period are: Local merchandise purchases at cost, $700; Head office merchandise shipments at billing price, $3,888.

BRANCH OFFICE BOOKS

JOURNAL ENTRIES

(NOTE: Numbers at the left refer to the transactions.)

1.	Cash	$ 500	
	Advertising Expense	300	
	Merchandise from Head Office	5,190	
	Fixtures	2,000	
	Building	5,000	
	Land	2,500	
	Head Office Current Account		$ 800
	Head Office Merchandise Shipments		5,190
	Head Office Investment Account		9,500
	To record opening of branch.		
3.	Merchandise from Head Office	15,120	
	Head Office Merchandise Shipments		15,120
	For merchandise received.		
4.	Remittances to Head Office	15,000	
	Cash		15,000
	For cash remittances.		
5.	Cash	18,000	
	Accounts Receivable	12,000	
	Sales		30,000
	To record sales.		
6.	Purchases	4,200	
	Cash		4,200
	To record cash purchases.		
7.	Cash	9,800	
	Accounts Receivable		9,800
	Collections.		
8.	Advertising Expense	900	
	Head Office Current Account		900
	For advertising supplied by Head Office.		
9.	Advertising Expense	660	
	Salaries and Wages	5,040	
	Light and Heat	480	
	Maintenance	1,200	
	Cash		7,380
	For expenses.		
10.	Bad Debts	230	
	Reserve for Bad Debts		230
	To set up reserve for bad debts.		
11.	Depreciation Expense	225	
	Reserve for Depreciation		225
	To record depreciation for six months.		

12. Sales	30,000	
Inventory, Local Merchandise	700	
Inventory, Head Office Merchandise	3,888	
Head Office Merchandise Shipments	16,422	
Purchases		4,200
Merchandise from Head Office		20,310
Advertising Expense		1,860
Salaries and Wages		5,040
Light and Heat		480
Maintenance		1,200
Bad Debts		230
Depreciation		225
Head Office Current Account		17,465
To close operating accounts.		
Head Office Current Account	15,000	
Remittances to Head Office		15,000
To close Remittance account.		

Closing Entries, Alternative Procedure:

Since the branch does not know the actual value of the closing inventory of goods received from the head office, it is impossible to determine the true profit (or loss) resulting from branch operations from the branch books. Accordingly, as has been indicated, the branch books may be closed without the use of the familiar Profit and Loss account. This is most easily accomplished by the one compound entry (No. 12) as shown in the preceding entries. The following method of closing accomplishes the same purpose:

Inventory, Local Merchandise	$ 700	
Inventory, Head Office Merchandise	3,888	
Purchases		$ 700
Merchandise from Head Office		3,888
To set up inventories, Dec. 31.		
Head Office Merchandise Shipments	16,422	
Head Office Current Account		16,422
To credit Head Office with goods supplied and to reduce Head Office Shipments account to inventory value.		
Sales	30,000	
Profit and Loss		30,000
To close Sales account.		
Profit and Loss	19,922	
Purchases		3,500
Merchandise from Head Office		16,422
To close "cost" of goods sold to Profit and Loss account.		
Profit and Loss	9,035	
Advertising Expense		1,860
Salaries and Wages		5,040
Light and Heat		480
Maintenance		1,200
Bad Debts		230
Depreciation		225
To close expenses to Profit and Loss account.		
Profit and Loss	1,043	
Head Office Current Account		1,043
To credit head office with the profit as determined from the branch books.		

The use of the foregoing alternative entries will in no way alter the balance sheet prepared from the branch books. Note that the balance of the Head Office Current Account is the same no matter which method is used.

Head Office Current Account

(First Method)

(12) Remittances	$15,000	(1) Cash, etc.	$ 800
Balance	4,165	(8) Advertising	900
		(12) Profit and Loss	17,465
	$19,165		$19,165

(Second Method)

(12) Remittances	$15,000	(1) Cash, etc.	$ 800
Balance	4,165	(8) Advertising	900
		(12) Merchandise	16,422
		(12) Profit and Loss	1,043
	$19,165		$19,165

It will be of interest to compare the "profit" of $1,043 determined from the foregoing entries with the "profit not included in billing price of goods sold" as determined from closing entries on the head-office books.

HEAD-OFFICE BOOKS

Journal Entries

(Note: Numbers at the left refer to the transactions.)

1. Branch A Current Account	$ 800	
Branch A Merchandise Shipments	5,190	
Branch A Investment Account	9,500	
Cash		$10,000
Branch Merchandise Shipments		5,190
Advertising Supplies		300
To record opening of Branch A.		
3. Branch A Merchandise Shipments	15,120	
Branch Merchandise Shipments		15,120
Merchandise shipped.		
4. Cash	15,000	
Branch A Current Account		15,000
For cash remittances.		
8. Branch A Current Account	900	
Advertising Expense		900
For advertising supplied Branch A.		

12. Branch Merchandise Shipments	20,310	
Purchases		16,925
Reserve for Unrealized Profit in Branch Inventory		648
Branch Profit and Loss		2,737

To credit Purchases account with cost of merchandise sent to branch ($\frac{5}{6}$ ×\$20,310), to set up Reserve for Unrealized Profit in Branch Inventory ($\frac{1}{6}$ ×\$3,888), and to credit branch earnings with profit included in billing price of goods sold ($\frac{1}{6}$×\$16,422.)

Branch A Current Account	17,465	
Branch A Merchandise Shipments		16,422
Branch Profit and Loss		1,043

To charge Branch A Current Account with merchandise shipments and to take up profits not included in billing price of goods sold.

BRANCH A
Statement of Profit and Loss
Six Months Ended December 31, 19__

Sales			$30,000
Less Cost of Goods Sold:			
Inventory, July 1		$ 4,325	
Purchases	$ 4,200		
Head Office Shipments	12,600	16,800	
		$21,125	
Inventory Dec. 31,			
Local Merchandise	$ 700		
Head Office Merchandise	3,240	3,940	
Cost of Goods Sold			17,185
Gross Profit on Sales			$12,815
Less Expenses:			
Advertising		$ 1,860	
Salaries and Wages		5,040	
Light and Heat		480	
Maintenance		1,200	
Bad Debts		230	
Depreciation		225	
Total Expense			9,035
Net Profit for Six Months			$ 3,780

Illustration 3

BRANCH A
Balance Sheet
December 31, 19__
(As per Branch Books)

Cash		$ 1,720	Head Office Accounts:	
Accounts Receivable	$2,200		Current	$ 4,165
Bad Debts Reserve	230	1,970	Merchandise	3,888
			Investment	9,500
Inventories		4,588		
Fixtures	$2,000			
Building	5,000			
	$7,000			
Depreciation Reserve	225	6,775		
Land		2,500		
		$17,553		$17,553

Illustration 4

Branch A Accounts at Head Office

Branch A Current Account	$ 4,165
Branch A Merchandise Shipments	3,888
Branch A Investment Account	9,500
	$17,553
Reserve for Unrealized Profit in Branch Inventory	648
	$16,905

Note.—As the company's investment in fixed assets at the branch is gradually recovered through depreciation charges, the Branch A Investment Account represents a decreasing fixed asset value and an increasing current asset value. Since the current values are usually represented by the Branch A Current Account, it is advisable that the Investment Account be amortized to the Current Account as the fixed assets are depreciated. Hence, at this time, the head office should introduce the following entry:

Branch A Current Account	$225	
Branch A Investment Account		$225

A corresponding entry should be made on the branch books, as follows:

Head Office Investment Account	$225	
Head Office Current Account		$225

Summary

Following, in summary form, is given a brief statement concerning each of the account titles peculiar to branch-house accounting.

Head-Office Books:

(1) *Branch Current Account:* This account may be the only account kept with the branch. It is, in such case, charged with all values sent to the branch and, at the end of the period, with the profit earned by the branch. It is credited with all values returned by the branch, with remittances, and, if the branch suffers a loss, with the amount of the loss. If no other account is kept with the branch, this measures, on any balance sheet date, the net investment in the branch. If a

Branch Investment Account is carried, see paragraph (4), the current account measures only the working capital at the branch.

(2) *Branch Merchandise Account:* This account is not usually employed if merchandise is billed to the branch at cost. If any other price is used, this account is a convenience. It is charged at billing price with merchandise sent to the branch and credited with merchandise returned. At the end of each period, the account is credited with the difference between the total shipments less returns and the amount of the inventory at the branch, the debit being to Branch Current account. The balance of the account is thus the value of the inventory at the branch priced at either *selling price* or an *arbitrary price* depending on the billing practice followed by the head office.

(3) *Shipments to Branches:* This account is credited when Branch Merchandise Account is charged with goods sent to branches. It should be borne in mind that these accounts are employed when the branches are charged at *selling price* or at an *arbitrary price* between the actual cost price and the selling price. At the end of each period, the account is closed, offsetting credits being made:

1. To *Purchases* for the cost price of the goods shipped.
2. To *Reserve for Unrealized Profit in Branch Inventory* for the difference between the cost price and the billed price of the goods still unsold at the branch.
3. To *Branch Profit and Loss* account for the remainder.

At the beginning of the next fiscal period, Shipments to Branches account is credited for the billed price of the inventory at the branch (that is, with the balance of the Branch Merchandise account), the debits being to Purchases account for the cost of the goods and to Reserve for Unrealized Profit in Branch Inventory for the balance of that account.

(4) *Branch Investment Account:* If the fixed assets at the branch are carried on the branch books, the Branch Investment Account may be debited with the cost of such assets. Cost should include invoice price, freight, installation expense, and any other charge which under the given circumstances may properly be capitalized. The account is credited at the end of each fiscal period with the amount provided for depreciation during that period. The debit is to Branch Current Account. (See Note after Illustrative Case No. 3.)

Branch Books:

(1) *Head Office Current Account:* This may be the only account kept with the head office. It is credited with all values advanced by the head office. It is charged with all values returned to the head office. Cash remittances may be charged directly to the account. (See paragraph 4.) Each period it is credited with the profit (or charged with the loss) determined from the branch books.

(2) *Merchandise from Head Office:* This account is charged at *billed price* for all merchandise received from the head office. It is credited for goods returned to the head office or sent to other branches on orders from the head office. At the end of the period it is closed, the offsetting debits being to Inventory for the *billed price* of unsold goods and to Head Office Current Account for the balance. If, notwithstanding the fact that goods have not been charged to the branch at cost, a Profit and Loss account is set up, the balance of the Merchandise from Head Office Account is closed to the Profit and Loss account and not directly to the Head Office Current Account. Subsequently the balance of the Profit and Loss account is closed to the Head Office Current Account.

(3) *Head Office Merchandise:* This account is credited when Merchandise from Head Office is debited. It measures the branch's accountability to the head office for merchandise. When the branch books are closed, the account is debited with the difference between the "cost" of goods received from the head office and the "cost" of the inventory on hand. "Cost" is, in the transactions recorded in this account, the billing price used by the head office and not actual cost to the head office. The credit is to Head Office Current Account.

(4) *Remittances to Head Office:* It is customary to record in an account of this title all cash remittances to the head office. At the end of the period the account is closed to Head Office Current Account.

(5) *Head Office Investment Account:* This account measures the investment in the fixed assets of the branch. It is credited with the value of fixed equipment supplied from the head office, from another branch, or paid for by the head office. It is debited with the carrying value of fixed assets abandoned, transferred to other branches, returned to the head office, destroyed, or sold. At the end of each fiscal period the account is debited with an amount equal to the current provision for depreciation expense, the offsetting credit being to Head Office Current Account. It should be understood that this adjustment is in addition to, not in lieu of, the regular debit to Depreciation Expense and credit to the Reserve for Depreciation.

5. Adjusting Entries.—At the end of each fiscal period it is likely that certain adjusting entries must be made prior to the preparation of financial statements. If fixed assets used by the branch are carried on the head-office books, the profits reported by the branch will not include an allowance for depreciation. The regular addition to the reserve for depreciation should be made on the head-office books by crediting the reserve and debiting the branch profit and loss account.

One or more adjusting entries may be necessitated by the fact that the Branch Current Account and Home Office Current Account are not truly reciprocal at the end of the fiscal period. This may arise because of the fact that the branch has not received merchandise that has been forwarded and charged by the head office, or because the head office has not received a remittance that has been forwarded by the branch and charged to the Head Office Current Account on the branch books. For the first situation, the branch records should be adjusted as follows: Debit Merchandise from Head Office in Transit and credit Head Office Current Account or, if merchandise receipts are not handled through this account, credit Head Office Merchandise Shipments account as was indicated in Illustrative Case No. 3, Art. 4.

The second situation mentioned in the preceding paragraph is handled in a similar manner. The head office records should be adjusted by a debit to Cash in Transit and a credit to the current account of the branch which has forwarded the remittance.

It may be customary for the head office to charge each branch with the cost of certain services that are performed for the branch. These services are usually accounting service, advertising, superintendence, and services of similar nature. Certain of these services, particularly advertising (see entry No. 8 of Illustrative Case No. 3, Art. 4), may be charged to the branch at the time the service is rendered or shortly thereafter. Other items may not be charged until the end of the fiscal period in which they occur. At this time, these expenses are prorated among the branches on some satisfactory basis. The entry to accomplish this is self-evident:

Branch A, Profit and Loss	$xxxx	
Branch B, Profit and Loss	xxxx	
Accounting and Auditing Expense . . .		$xxxx
Legal Expense		xxxx
To charge branches with pro rata shares of these expenses.		

6. Interbranch Transfers and Freight Charges.—Some companies attempt to follow the policy of removing merchandise from a branch if such merchandise remains unsold over a certain number of days. Obviously this policy does not affect staple goods, but may effect goods in which style is a dominant factor. Ordinarily branches do not carry accounts with each other in which these transfers can be recorded. It is customary for these transactions to be handled by each branch as if the merchandise were returned to or received from the head office.

As is the case with an independent store, the branch should add the cost of freight and cartage-in to the invoice cost of merchandise received from the head office. If a certain portion of merchandise so received is subsequently transferred to a second branch it will be necessary for the shipping or the receiving branch to pay freight charges on the reshipment. It is almost inevitable that it will cost more in freight charges to send merchandise to Branch B via Branch A than it would cost to ship the same merchandise directly from the head office to Branch B. Branch B should not add to the cost of such merchandise more than the freight that would be paid on a direct shipment from the head office. Any excess freight involved because of the shipment via Branch A should be written off to expense immediately.

The following illustrative case will serve to clarify these points. Journal entries are given to record the following transactions:

1. Branch A receives from the head office merchandise listed at cost price of $1,000. Freight of $80 is paid in cash by the branch.
2. One-fourth of the merchandise mentioned in transaction 1 is reshipped by Branch A to Branch B, freight charges collect. It may be assumed that the $80 freight charge paid originally may be prorated over the entire shipment in proportion to cost price.

3. The merchandise shipment is received by Branch B and a freight charge of $14.00 is paid in cash. Branch B is much nearer the head office than is Branch A, and the freight charges on a similar shipment made directly from the head office would be only $8.00.

JOURNAL ENTRIES

Head-Office Books

Branch A Current Account	$1,000	
Purchases.		$1,000
Goods shipped to Branch A.		
Branch B Current Account	250	
Inter-Branch Freight.	20	
Branch A Current Account		270
Goods from Branch A to Branch B.		
Inter-Branch Freight	6	
Branch B Current Account		6
To credit Branch B for difference between freight paid ($14.00) and direct freight ($8.00.)		

Note:

Total freight charges paid $20 (A)+$14 (B) =	$34
Freight on direct shipment	8
Excess due to reshipment	$26

Branch A Books

Merchandise from Head Office	$1,000	
Freight In	80	
Head Office Current Account		$1,000
Cash		80
Goods received from head office.		
Head Office Current Account.	270	
Merchandise from Head Office		250
Freight In		20
Goods shipped to Branch B as per instructions of Head Office order No. ———		

Branch B Books

Merchandise from Head Office	$ 250	
Freight In	8	
Head Office Current Account		$244
Cash		14
Merchandise from Branch A.		

QUESTIONS AND PROBLEMS

Answers and solutions to the following questions and problems are now to be prepared by you after careful study of the foregoing chapter. Any good quality of paper on which your work will appear neat and legible may be used.

(1) What entry should be made on the branch books to record the receipt of merchandise from the head office if the merchandise is billed to the branch (*a*) at cost? (*b*) at selling price?

(2) The following accounts appear in the Branch No. 25 and the Head Office trial balances December 31, 19__: Head Office Current Account (credit) $42,350 and Branch No. 25 Current Account (debit) $38,780. How do you account for this difference?

(3) A certain company carries two accounts with each of its branches, namely, Branch Current Account and Branch Investment Account. For what should an adjustment be made between these accounts? When?

(4) A branch manager receives a bonus of 10 per cent. of the branch profits. The fixed assets of the branch are carried on the head-office books. Certain expenses incurred for the benefit of all branches are paid by the head office and prorated monthly among the branches.

To enable the branch manager to determine his profit or loss for the month just ended, the head office sends him the following statement:

Advertising	$180
Legal expense	50
Depreciation	150

Give journal entries to set up this information on the branch books.

(5) A branch office business was started at the first of the year, the head office advancing $5,000 cash. During the first year, merchandise that cost $75,000 was shipped to the branch.

An auditor, checking up the business at the close of the year, found the following: Merchandise sales were $60,000. The cost of merchandise sold was $50,000. Proper vouchers and receipts were on file for the following: Rebates and allowances on damaged goods $1,500; salaries and other expenses paid $7,000.

The books also showed: Remittances to head office $35,000; uncollected accounts $15,000. The balance of sales had been realized in cash, less rebates and allowances as noted. The cash on hand and inventory of unsold goods, together with the foregoing facts, properly accounted for all assets. Prepare:

(*a*) Entries to record transactions on branch books.
(*b*) Branch closing entries.

(*c*) Branch balance sheet.
(*d*) Branch profit and loss statement.

(6) On January 1 the balance sheet of Branch No. 42 showed assets of $165,000 and liabilities of $55,000.

During the year merchandise that cost $740,000 was received from the home office.

Remittances were made to the home office as follows: $85,000; $240,000; $300,000 and $180,000.

$25,000 worth of merchandise was shipped to Branch No. 28 as ordered by the home office.

The profit of Branch No. 42 for the year was $128,000. Show, in as complete detail as possible, the Branch No. 42 Current Account on the home office books.

(7) The Flowers Company ships merchandise to its branches at a uniform mark up of 25 per cent. above cost. The branch managers are not aware of the exact percentage used. During a given month Branch 15 received merchandise billed at $105,000. At the close of the month, this branch reported: Inventory $42,000, expenses paid $14,000, collections from customers $49,500, bad debts $600, and sales on account $68,200. Remittances to the head office were $35,000.

Give journal entries to record the foregoing transactions on the branch books and to close the branch books. Show Branch 15 Current Account and Branch 15 Profit and Loss Account on the head-office books.

(8) The White Company has selling agencies in several cities. Each manager of a Class A agency receives a salary of $350 per month directly from the head office. He pays his own store's expenses, which must not exceed $800 per month, and is reimbursed at the end of each month by the head office. The agencies carry samples only. Orders are filled by the head office, which also bills customers and makes collections.

At the end of a given month the agencies (both Class A) at Denver and Des Moines submit the following reports:

	Denver	Des Moines
Sales	$32,480	$41,320
Expenses	640	790

Rent on agency stores is paid directly by the head office each month. Present leases require payments: Denver $250, Des Moines $325.

What entries would you make to record on the head-office books the above transactions with the agencies and their customers?

Look over your answers and solutions to the above questions and problems, and immediately send them to the Schools for correction.

CHAPTER II

BUSINESS COMBINATIONS—MERGERS, CONSOLIDATIONS AND HOLDING CORPORATIONS

7. Reasons for Combinations.—During the past sixty years the world has witnessed several types of business combinations. Probably the chief motivating principle behind all combinations has been a desire to control the selling price of a product. Price control is a means of eliminating competition and then effecting a general rise in the price received for the product marketed by the combination. Combinations of railroads were among the first to receive legislative attention and the Interstate Commerce Act of 1887 was designed to protect the public against monopoly rates and service. Some time later, July 2, 1890, the Sherman Anti-Trust Act was passed. The principal objective of this act is the protection of the public against all "combinations in restraint of trade." Further legislation along this line came with the Clayton Act of 1914. This act is designed to prevent the acquisition of a substantial amount of the capital stock of one company by a second company that may be regarded as a "natural competitor" of the company whose stock it wishes to acquire. In other words, one company under this act may not acquire stock in another company if the effect of the acquisition is to lessen competition between the two companies.

Since it is illegal under several national and state statutes to combine *for the purpose of fixing price* or *controlling competition*, other reasons must be advanced to justify the formation of business combinations. Among those usually presented are first, to improve and centralize management; second, to advance and promote the use of certain products; third, to coordinate the activities of all companies handling a product from its raw material state through successive stages of production and distribution until it is placed in the hands of wholesaler, retailer, or even consumer; fourth, to eliminate duplication of effort in connection with buying, selling, and financing activities. For a specific business combination other reasons may be advanced.

8. Methods of Securing Unified Control.—There has been some confusion in the public mind concerning "corporations" and "trusts." There has been much greater confusion on the matter of business combinations. To the lay mind, a *community of interest*, a *pool*, an *interlocking directorate*, or a *voting trust* have been one and the same thing. These have been regarded as business combinations and, unfortunately, "business combinations in restraint of trade." It is quite true that each of the foregoing represents a type of business combination. It is undoubtedly true that these terms have been quite properly applied to some combinations that were very definitely in restraint of trade. It does not follow, however, that all

combinations are in restraint of trade nor that all combinations are properly known by the titles mentioned.

There are four principal methods of securing unified control in business. These will be enumerated and described briefly:

1. *Trusts.*—A trust may be established in either of two ways. In the first place, the owners of the capital stock of various companies may assign their stock to a *board of trustees*, receiving in exchange *certificates of beneficial interest*. In the second place, the board of trustees may sell outright certificates of beneficial interest in the trust and may use the funds thus obtained to acquire stock in various companies, bonds of various companies, or any other assets which are desired by the board of trustees. Regardless of the manner in which the certificates of beneficial interest originate, it is understood that the trustees will operate the property for the benefit of the beneficiaries. From the income obtained, dividends are paid to the holders of the trust certificates. There has been great popular aversion to this type of business combination. It was at this type primarily that antitrust legislation was aimed.

2. *Mergers.*—A merger occurs when one corporation absorbs, that is, *merges with itself*, one or more other corporations. The businesses that are merged may give up their property in exchange for cash or in exchange for capital stock of the one company to be continued. In the majority of instances, the exchange seems to be made for shares of stock. In either event, the merged corporations disappear. Liquidating dividends are paid to the shareholders of these companies and their capital-stock certificates taken up and canceled. Depending on the method used in the merger, the liquidating dividends may be in either cash or capital stock of the buying corporation.

3. *Consolidations.*—In many respects, a consolidation is not unlike a merger. The principal difference arises from the fact that instead of merging into an existing corporation, the various corporations involved participate in the formation of a wholly new corporation. The assets and liabilities of the consolidating companies are transferred to the consolidated corporation in exchange for the latter's capital stock. Not infrequently subsequent additions to consolidations may be made by outright cash purchases.

4. *Holding Companies.*—Unquestionably the most important and most widely used type of business combination is the holding corporation. The holding corporation secures control of other corporations through stock ownership. It is the primary object of the holding corporation to secure sufficiently large blocks of stock in other corporations to be able to obtain voting control of these other corporations. When a corporation is controlled through stock in the hands of a holding corporation, it is known as a *subsidiary corporation* of the holding or *parent* corporation. The amount of stock that must be held in order to secure control of a corporation varies. Ordinarily 51 per cent. of the voting stock is regarded as a controlling interest. In some instances, however, control may be acquired for all practical purposes through the ownership of a much smaller

percentage of voting stock. This is particularly true if the uncontrolled portion of the stock is very widely distributed. On the other hand, complete control may not always be secured through the ownership of a mere majority of the shares outstanding. It is true in some corporations that the by-laws of the corporation may not be changed unless approval is secured from 60 or 75 per cent. of the outstanding shares. This would indicate that the holding company in possession of 55 per cent. of the capital stock could maintain control in all ordinary situations, but could not change the corporation's by-laws without securing the assistance of other shareholders. Such shares as are not in possession of the holding corporation or of its subsidiary corporations are said to be in possession of the *minority interest*. It is important to recognize the fact that a corporation is not a holding company simply because it owns shares of stock in other corporations. The ownership must be of a sufficiently large block of stock to enable the owning company to control the activities of the subsidiary company.

9. Adjustment of Book Values Required by a Merger or Consolidation. Only rarely would a merger or a consolidation take place without some alteration of the book values presented by one or more of the participating organizations. Adjustments of this nature come about because of the lack of uniformity in the accounting practices of the various companies. It may be, for example, that two of the parties to a prospective merger use identical machines but that one company depreciates its machines on a ten-year life estimate while the other depreciates a like asset over an estimated life of twelve or fifteen years. It is important, of course, that the life estimate be as accurate as accountants, engineers, and others interested can predict, but it is even more important in a merger that accounting principles be applied uniformly in order that the stockholders of the more conservative corporation shall not be discriminated against in favor of those of less conservative corporations.

A second example of the need for uniformity in such cases may be based on the asset, Accounts Receivable. The accounts receivable of all parties to the merger (or consolidation) are taken up by the remaining corporation (or the new corporation). If one company records provision for bad debts *before the debts are found to be uncollectible* and a second company recognizes bad debts only *when the accounts are written off*, the accounts of the latter company are less conservatively stated than are those of the first company. Hence, at the time of merging (or consolidating) the companies, the receivables are not stated on a comparable basis until provision has been made on the books of the second company for such losses as are likely to occur through failure to collect in full from customers. Still a third company to the merger may have included in its receivables such items as Advances to Salesmen, Loans to Officers, Advances to Subsidiary Companies, and similar items obviously not due from trade debtors. It is the duty of the accountant to remove all such extraneous items and to state the accounts receivable on a comparable basis.

Another illustration of the importance of this problem of uniformity in accounts is found if one of the participating organizations is a partnership. The net profit

of a corporation is stated after the deduction of managerial salaries and bonuses along with all other expenses. In a partnership, however, alternative treatments are found in regard to salaries and bonuses. The partners may:

1. Receive no salaries as such.
2. Draw relatively small salaries, leaving much to be distributed as profit.
3. Draw relatively large salaries, leaving little to be distributed as profit.
4. Draw salaries only if the salaries are earned through operations.
5. Charge salaries and bonuses to expense accounts.
6. Charge these items as distributions of net profits.

It will be seen at once that the net profits of the participating organizations are not comparably stated unless the salaries in both types of organization are treated in the same manner.

The foregoing principles apply not only to the specific accounts mentioned but to practically all accounts. If one company is on an *accrual basis* and a second reports income on a *cash basis*, adjustments must be made before the statements can be compared. If one company has written off bond discount against surplus and a second company is accumulating discount over the life of the bonds, adjustments are required. Other cases, too numerous to mention here, require similar adjustments.

10. Illustration of a Merger.—Following are shown the profits over a five-year period and the balance sheets of companies A, B, and C as of December 31, 1932. For some time the principal owners of the three companies have been considering plans under which the companies might unite in order to operate more effectively against increasing competition. It has been agreed that companies B and C shall be merged with A Company under the following terms:

1. Reserves for Bad Debts shall be increased to: B Company, $2,500; C Company, $1,500.
2. Reserves for Depreciation shall be: B Company, $25,000; C Company, $20,000.
3. C Company shall write off $3,000 of deferred charges.
4. Land shall be valued: A Company, $10,000; B Company, $15,000; C Company, $5,500.
5. Companies B and C shall be assumed to have goodwill in amounts equal to three times their average annual profit over the past five years.
6. Payment to be made in common stock of A Company.

The profits for each of the companies for each of the five years are as follows and balance sheets are shown in Illustration 5.

Profits by Years

Year	A	B	C
1928	$ 2,000	$ 2,000	$10,000
1929	6,000	2,200	7,000
1930	8,000	2,800	5,000
1931	12,000	4,000	1,000*
1932	10,000	3,000	3,000*
	$38,000	$14,000	$18,000
Average	$ 7,600	$ 2,800	$ 3,600

*Loss

Balance Sheets

December 31, 1932

	A Company	B Company	C Company
Assets			
Cash	$ 15,000	$ 10,000	$ 2,000
Receivables	25,000	35,000	15,000
Inventories	30,000	20,000	30,000
Fixtures	8,000	4,000	5,000
Plant and Equipment		65,000	50,000
Buildings	20,000		
Land	6,000	10,000	10,000
Deferred Charges	1,000	3,000	4,000
Goodwill			25,000
	$105,000	$147,000	$141,000
Liabilities and Capital			
Current Payables	$ 20,000	$ 25,000	$ 15,000
Reserve for Bad Debts	1,000	1,000	
Reserve for Depreciation	3,000	30,000	10,000
Bonds Payable		50,000	25,000
Capital Stock Issued	75,000	25,000	60,000
Surplus	6,000	16,000	31,000
	$105,000	$147,000	$141,000

Illustration 5

Adjusting Entries

B Company:

Surplus	$ 1,500	
Reserve for Bad Debts		$ 1,500
To revalue Receivables.		
Reserve for Depreciation	5,000	
Land	5,000	
Goodwill	8,400	
Surplus		18,400
To revalue assets and to set up goodwill prior to merger.		

C Company:

Surplus	$33,200	
Reserve for Bad Debts		$ 1,500
Reserve for Depreciation		10,000
Deferred Charges		3,000
Land		4,500
Goodwill		14,200
To revalue assets prior to merger with A Company.		

A Company:

Land	4,000	
Unrealized Profit in Land		4,000
To revalue Land account.		

Transfer Entries

B Company:

A Company, Vendee	$132,900	
Reserve for Bad Debts	2,500	
Reserve for Depreciation	25,000	
Cash		$10,000
Receivables		35,000
Inventories		20,000
Fixtures		4,000
Plant and Equipment		65,000
Land		15,000
Deferred Charges		3,000
Goodwill		8,400
To transfer assets to vendee.		
Current Payables	25,000	
Bonds Payable	50,000	
A Company, Vendee		75,000
To credit vendee with liabilities assumed.		
Stock of A Company	57,900	
A Company, Vendee		57,900
Payment by vendee.		

C Company:

A Company, Vendee	$97,800	
Reserve for Bad Debts	1,500	
Reserve for Depreciation	20,000	
Cash		$ 2,000
Receivables		15,000
Inventories		30,000
Fixtures		5,000
Plant and Equipment		50,000
Land		5,500
Deferred Charges		1,000
Goodwill		10,800
To transfer assets to vendee.		
Current Payables	15,000	
Bonds Payable	25,000	
A Company, Vendee		40,000
To credit vendee with liabilities assumed.		
Stock of A Company	57,800	
A Company, Vendee		57,800
Payment by Vendee.		

A Company:		
Cash	$10,000	
Receivables	35,000	
Inventories	20,000	
Fixtures	4,000	
Plant and Equipment	65,000	
Land	15,000	
Deferred Charges	3,000	
Goodwill	8,400	
Reserve for Bad Debts		$ 2,500
Reserve for Depreciation		25,000
B Company, Vendor		132,900
Purchase of assets of B Company.		
B Company, Vendor	75,000	
Current Payables		25,000
Bonds Payable		50,000
Liabilities of B Company assumed.		
NOTE.—Entries to record acquisition of of C Company are omitted. They can readily be prepared by reference to the two preceding entries and to entries of C Company.		
B Company, Vendor	57,900	
C Company, Vendor	57,800	
Capital Stock Issued		115,700
Payments to vendors.		

CLOSING ENTRIES

B Company:		
Capital Stock	25,000	
Surplus	32,900	
Stock of A Company		57,900
Record payment to shareholders of $231.60 per share and cancelation of stock certificates.		
C Company:		
Capital Stock	60,000	
Surplus		2,200
Stock of A Company		57,800
Record liquidation of capital claims at 96⅓ and cancelation of stock certificates.		

The condition of A Company after the foregoing entries have been recorded is shown in Illustration 6.

11. Illustration of a Consolidation.—The principal owners of companies One, Two, and Three conclude that their interests may be best served by effecting a consolidation. Accordingly, the formation of a new corporation to be known as Company X is undertaken. A charter is secured authorizing the issue of $500,000 in 5-per-cent. first preferred stock and $1,000,000 in common stock, each class having shares of $100 par value.

Company X is to take over the businesses of Companies One, Two, and Three. Professional accountants are employed to audit the books of each company for the

A COMPANY

BALANCE SHEET

December 31, 1932

Assets			
Cash		$ 27,000	
Receivables	$ 75,000		
Reserve for Bad Debts	5,000	70,000	
Inventories		80,000	
Total Current Assets			$177,000
Fixtures	$ 17,000		
Plant and Equipment	115,000		
Buildings	20,000		
	$152,000		
Reserve for Depreciation	48,000	$104,000	
Land		30,500	
Total Fixed Assets			134,500
Deferred Charges			5,000
Goodwill			19,200
			$335,700
Liabilities and Capital			
Current Payables			$ 60,000
Bonds Payable			75,000
Capital Equity:			
Capital Stock Issued		$190,700	
Surplus:			
Unrealized Profit in Land		4,000	
Unappropriated		6,000	
Total Net Worth			200,700
			$335,700

ILLUSTRATION 6

last five years and to determine the net worth of each at the date of consolidation. Attention is to be paid particularly to the *correctness* and *uniformity* of accounting procedures followed by each company in regard to the following points:

1. Provision for bad debts.
2. Provision for depreciation.
3. Salaries and other compensation of officers.
4. Inventory valuations.
5. Unearned and/or unrealized profits.
6. Methods of computing manufacturing costs.
7. Net profits each year.

The amount to be paid, in common stock of Company X, for each old company is to be computed as follows:

1. Determine the average yearly profit of each company over the past five years.
2. Determine the rate of return which this profit represents on the value of the net assets at the time of the consolidation.
3. Capitalize each company's average net earnings found in (1) by the lowest of the three rates found in (2).

The conclusions of the auditors are summarized below:

	Company One	Company Two	Company Three
Current Assets	$ 40,000	$ 80,000	$100,000
Fixed Assets	100,000	120,000	250,000
Total	$140,000	$200,000	$350,000
Liabilities	$ 35,000	$ 75,000	$200,000
Capital Stock	100,000	150,000	150,000
Surplus	5,000	25,000*	
	$140,000	$200,000	$350,000

Earnings

Year	Company One	Company Two	Company Three
1929	$ 4,000	$ 10,750	$ 8,000*
1930	10,000	25,000	3,000
1931	16,000	16,500	25,000
1932	24,000	10,000*	25,000
1933	30,000	11,000*	30,000
	$ 84,000	$ 31,250	$ 75,000
Average	$ 16,800	$ 6,250	$ 15,000
Rate	16%	5%	10%

*Deficit or Loss.

According to the instructions given in preceding paragraph (3), stock will be issued to each old Company as follows:

One	$16,800 ÷ .05 =	$336,000
Two	$ 6,250 ÷ .05 =	125,000
Three	$15,000 ÷ .05 =	300,000
Total		$761,000

Journal entries to record the transfers may be as follows: Alternative procedures are, however, given for the treatment of goodwill.

Journal Entries

Company One:

Goodwill	$231,000	
Surplus		$231,000
To set up goodwill.		
Company X, vendee	336,000	
Liabilities	35,000	
Current Assets		40,000
Fixed Assets		100,000
Goodwill		231,000
To record sale of business.		
Common Stock of Company X	336,000	
Company X, vendee		336,000
To record payment by vendee.		
Capital Stock	100,000	
Surplus	236,000	
Common Stock of Company X		336,000
To record redemption and cancelation of stock certificates.		

Company Two:

Entries are similar to those for Company One except for the final entry which is:

Capital Stock	$150,000	
Surplus		$ 25,000
Common Stock of Company X		125,000
To record liquidating dividend to shareholders of this corporation.		

Company Three:

Company X, Vendee	$300,000	
Liabilities	200,000	
Current Assets		$100,000
Fixed Assets		250,000
Surplus		150,000
To record transfer of assets to, and assumption of liabilities by, Company X and to set up gain on sale of business.		
Common Stock of Company X	300,000	
Company X, vendee		300,000
To record payment by vendee.		
Capital Stock	150,000	
Surplus	150,000	
Common Stock of Company X		300,000
To record dissolution of Company Three.		

Company X:

Unissued Preferred Stock	$ 500,000	
Unissued Common Stock	1,000,000	
5% First Preferred Stock		$ 500,000
Common Stock		1,000,000
To record stock authorization.		

Subscriptions to Common Stock . . .	$ 761,000	
Common Stock Subscribed . . .		$761,000
To record subscriptions.		
Company One 3,360 Shares		
Company Two 1,250 "		
Company Three 3,000 "		
7,610 Shares		

Current Assets	40,000	
Fixed Assets	100,000	
Goodwill	231,000	
Liabilities		35,000
Company One, vendor		336,000
To record acquisition of Company One.		

Entries similar to the foregoing are made to record acquisition of companies Two and Three.

Company One, vendor	$ 336,000	
Company Two, vendor	125,000	
Company Three, vendor	300,000	
Subscriptions to Common Stock . .		$ 761,000
To offset subscription claims against obligations to vendors.		

Common Stock Subscribed	761,000	
Unissued Common Stock		761,000
To record issuing of stock certificates.		

After the required entries have been made on the books of Company X, the balance sheet of Company X will be as shown in Illustration 7.

COMPANY X
BALANCE SHEET
December 31, 1933

Current Assets	$ 220,000	Liabilities		$ 310,000
Fixed Assets	470,000	Unissued Preferred Stock . . .	$ 500,000	
Goodwill	381,000	Authorized Common Stock . . .	1,000,000	
		Less Unissued .	239,000	
		Outstanding		761,000
	$1,071,000			$1,071,000

ILLUSTRATION 7

12. Other Bases for Stock Allotments.—In the foregoing example, each party to the consolidation received in payment for its net assets only common stock of the new company. It should be noted that the method followed in determining the amount of common stock to be given to each old company resulted in payments *proportionate to the earnings of the old companies* not to the net assets contributed by each old company. The result was as follows:

COMPANY	NET ASSETS	PER CENT.	EARNINGS	PER CENT.	STOCK	PER CENT.
One	$105,000	27.63	$16,800	44.15	$336,000	44.15
Two	125,000	32.90	6,250	16.43	125,000	16.43
Three	150,000	39.47	15,000	39.42	300,000	39.42
Totals . .	$380,000	100.00	$38,050	100.00	$761,000	100.00

Such a distribution means that the stockholders of the old companies (who now hold the stock of Company X) will participate relatively in future earnings as they participated in earnings (not necessarily *dividends*) during the last five years. Voting power is given in largest measure to the stockholders of old Company One, the company that demonstrated its ability to secure the greatest return on its investment.

Whether or not this plan is equitable depends on many factors not indicated in the foregoing illustration. The declining annual earnings of Company Two seem to indicate a total absence of goodwill. This conclusion is substantiated by the very low average earnings. (The *average* would, of course, remain the same if $6,250 had been earned during each of the five years.) The best year (1930), however, showed a net profit of $16\frac{2}{3}$ per cent. on *capital stock* (net capital of that year is not known) and it is possible that the company enjoys high potential goodwill which, under the new management, will produce a much higher return on the net assets.

The interested parties should be advised by their accountants of the inequalities that will result from the given stock distribution *if the new company fails shortly after its organization.* Assume, for illustrative purposes, that 1934 operations result in a loss of $100,000. The working-capital position of Company X would be even weaker than the unsatisfactory one indicated in the balance sheet, Illustration 7. The creditors might force the company into bankruptcy with its resulting expenses and losses on realization of assets. Assume that the assets, exclusive of goodwill, realize $500,000 (probably a high estimate) and that expenses are held to $21,000. The resulting balance sheet might appear as in Illustration 8.

COMPANY X
BALANCE SHEET
December 31, 1934

Cash	$ 479,000	Liabilities	$ 310,000
Goodwill	381,000	Common Stock	761,000
Deficit	211,000		
	$1,071,000		$1,071,000

ILLUSTRATION 8

After liquidation of creditors' claims, there is $169,000 or $22.21 per share available to common stockholders. The following comparison may be made.

Company	Net Assets Contributed	Liquidation Dividend	Loss: Amount	Loss: Per Cent. of Contribution
One	$105,000	$ 74,617.61	$ 30,382.39	28.93
Two	125,000	27,759.53	97,240.47	77.79
Three	150,000	66,622.86	83,377.14	55.58
	$380,000	$169,000.00	$211,000.00	

To guard against this situation's arising, the stockholders of Companies Two and Three may insist on some method of payment other than that just described. One common solution of the difficulty is found in issuing preferred shares for the net assets and common shares for the goodwill. The preferred stock should be preferred as to both dividends and assets. Under the preference as to assets, the stockholders will share in any liquidating dividend (up to the amount of their original net assets contributions) in proportion to the assets contributed. In determining the amount of common stock to be issued for goodwill, the *earnings should first be reduced by the return on preferred shares issued* for net assets contributed. If this plan were applied in the consolidation outlined in Art. 11, the resulting stock payments would be:

	Total	One	Two	Three
For Net Assets:				
5% Preferred Stock .	$380,000	$105,000	$125,000	$150,000
For Goodwill:				
Common Stock . . .	381,000	231,000*		150,000†
Total	$761,000	$336,000	$125,000	$300,000

*[$16,800 − (.05 × $105,000)] ÷ .05 = $231,000
†[$15,000 − (.05 × $150,000)] ÷ .05 = $150,000

In order to reduce the amount of stock issued for goodwill, the interested parties may decide upon a higher capitalization rate. This will not change the participation of old stockholders in excess profits earned by the new company if, as indicated in the foregoing tabulation, the earnings used are first reduced by the dividend requirements of the preferred shares issued for net assets. To demonstrate the truth of this assertion, it may be assumed that the net profits in 1934 are $41,860. Under the 5-per-cent. capitalization rate as used in the foregoing, dividends are payable as follows if the directors distribute the entire earnings:

	Total	To Shareholders of Company: One	Two	Three
Preferred Dividends:				
5% on $105,000	$ 5,250	$ 5,250		
5% on $125,000	6,250		$ 6,250	
5% on $150,000	7,500			$ 7,500
Common Dividends:				
6% on $231,000	13,860	13,860		
6% on $150,000	9,000			9,000
Totals	$41,860	$19,110	$ 6,250	$16,500

If the earnings were capitalized at 15 per cent. instead of 5 per cent., only $127,000 would be set up for goodwill, and the distribution of net earnings of $41,860 would be as follows:

	Totals	To Shareholders of Company: One	Two	Three
Preferred Dividends:				
(As before)	$19,000	$ 5,250	$ 6,250	$ 7,500
Common Dividends:				
18% on $77,000	13,860	13,860		
18% on $50,000	9,000			9,000
Totals	$41,860	$19,110	$ 6,250	$16,500

If, instead of making profits, Company X sustains severe losses and is forced into bankruptcy, the liquidating dividends will be paid to the shareholders of each old company in proportion to the net assets contributed to the consolidation. This will be as indicated in the following tabulation if the condition of the company immediately prior to the liquidating dividend is that exhibited by the balance sheet shown in Illustration 8.

Company	Net Assets Contributed	Liquidation Dividend*	Loss: Amount	Loss: Per Cent. of Contribution
One	$105,000	$ 46,697.37	$ 58,302.63	55.526
Two	125,000	55,592.11	69,407.89	55.526
Three	150,000	66,710.52	83,289.48	55.526
	$380,000	$169,000.00	$211,000.00	

*Preferred: 44.47368 per cent. Common: None.

The foregoing discussion explains the advantages and disadvantages, from the viewpoint of any old stockholder, attending the use of either common stock or a combination of common and preferred stocks in payment to the old companies for their properties. Company Two's stockholders gain in the event of liquidation if preferred stock has been issued for net assets. But they are apparently limited to a return of 5 per cent. on the value of their net-asset contribution.

A variation of this plan will be obvious. The preferred shares may be made equally participating with the common shares after the latter have received a dividend equal to that paid on the preferred shares. If this provision is adopted, the assumed profit of $41,860 would be divided as follows:

	Total	To Shareholders of Company: One	Two	Three
Preferred Dividends:				
5% on $105,000	$ 5,250	$ 5,250		
5% on $125,000	6,250		$ 6,250	
5% on $150,000	7,500			$ 7,500
Extra Dividend:				
Approximately ½ of 1%* .	1,903	526	626	751
Common Dividends:				
5% on $231,000	11,550	11,550		
5% on $150,000	7,500			7,500
Extra Dividend:				
Approximately ½ of 1%* . .	1,907	1,156		751
Totals	$41,860	$18,482	$ 6,876	$16,502

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The following indicates the distribution that will be made if the directors declare a dividend of $41,860 and if excess earnings were capitalized at 15 per cent. in determining goodwill.

	Total	To Shareholders of Company: One	Two	Three
Preferred Dividends:				
Regular, 5%	$19,000	$ 5,250	$ 6,250	$ 7,500
Extra*	12,375	3,419	4,071	4,885
Common Dividends:				
Regular, 5%	6,350	3,850		2,500
Extra*	4,135	2,507		1,628
Totals	$41,860	$15,026	$10,321	$16,513

*Approximately 3½ per cent.

These alternative distributions emphasize the fact that the participation of the preferred shares exerts a marked influence *in the selecting of the capitalization rate to be used in computing goodwill.* It has already been demonstrated that, with non-participating preferred shares issued for net assets, the exact rate to be used in the capitalizing of excess profits is immaterial, depending solely, in fact, on the *amount* of goodwill that the directors deem appropriate. The use of participating preferred shares reduces the *amount* available to common shares (after the *preferred* rate has been paid on *common* shares) with the result that the total return to common shareholders *is* directly influenced by the amount of common stock issued.

13. The Use of Bonds.—Bonds of the new company may be issued in full or part payment for the net assets of the old companies. If bonds are used in part payment only, say from one-fourth to three-fourths, the balance due for net assets is likely to be paid in preferred stock. Goodwill is almost always paid for by the issue of common stock.

The use of bonds, particularly of mortgage bonds, strengthens the position of the stockholders of the old companies but definitely weakens the position of the new corporation. The bond interest is a fixed charge (unless income bonds are used) which must be paid whether or not earnings before interest equal the interest requirements. Dividends on preferred shares, of course, cannot be declared unless surplus is available for the purpose.

In determining the amount of excess profits attributable to goodwill, the total net profit should first be reduced by both interest on bonds and dividend requirements of the preferred stock.

14. Other Methods of Determining Goodwill.—It has long been the opinion of the writer that the recognition of goodwill in accounts is solely a matter of *bargaining power.* Some methods of arriving at the *amount* of goodwill to be set up, however, are certainly more "scientific" than others. Some methods, scientific or not, produce relatively large amounts of goodwill, while others result in ultra conservative valuations. If A and B have *opposite self-interests,* a payment by one to the other for goodwill warrants the setting up of this amount as goodwill. It should be noted that the amount is set up, not because a payment was made, but because two parties with *diametrically opposed self-interests* included the payment in their bargain. The factors involved in computing goodwill usually include certain of the following: (1) the number of years' earnings to be considered, (2) the fair average rate of return in the particular field, (3) the number of years' profits or excess profits to be purchased. This is termed the number of years' purchase to be paid and (4) the rate of return to be used in capitalizing excess earnings. The selection of the *method* to be used is determined by bargaining power, and the *application* of the method involves the same power. The accountant should accept goodwill values with the proverbial grain of salt until he is satisfied that the amount is capable of strong defense.

In the consolidating or merging of several companies, the interests of one group of old stockholders can seldom be identical with those of another group. It is equally true that the interests of one group are rarely directly opposed to those of another group. Company X (referred to in Arts. 11 and 12) in dealing with Company Three, for example, may well be regarded as Company (1+2+3) dealing with Company Three and it is evident that the buyer and the seller do not have wholly distinct interests.

The following statement of assets and earnings may be used to illustrate certain goodwill procedures.

Following are illustrative cases.

	Company A	Company B	Company C
Net Assets	$200,000	$200,000	$400,000
Average Return	15%	15%	18%
Net Earnings:			
1928	$ 15,000	$ 40,000	$ 66,000
1929	25,000	35,000	80,000
1930	30,000	25,000	60,000
1931	35,000	30,000	91,000
1932	45,000	20,000	63,000
	$150,000	$150,000	$360,000
Average	$ 30,000	$ 30,000	$ 72,000

Case 1.—In Art. 11, goodwill was determined by capitalizing, at the average-earnings rate of the company having the lowest rate, the profits in excess of the product resulting from applying this rate to the net assets of the company. If that plan were followed here, only Company C would be regarded as possessed of goodwill. For example,

Average Earnings	$72,000
15% on $400,000	60,000
Excess Profits	$12,000
Goodwill: $12,000÷.15=	$80,000

Case 2.—It may be that the interested parties agree that a return of 12 per cent. on net assets is the average earning of representative firms in this particular line of business. In such case, it is argued, all companies enjoy goodwill and the result is as follows:

	A	B	C
Average Earnings	$ 30,000	$ 30,000	$ 72,000
12% on Net Assets	24,000	24,000	48,000
Excess Profits	$ 6,000	$ 6,000	$ 24,000
Goodwill (at 12%)	$ 50,000	$ 50,000	$200,000

Case 3.—The parties at interest may reach the conclusions indicated in Case 2 but may be opposed to setting up $300,000 as goodwill. *Bargaining* may result in the application of a 20-per-cent. rate to the excess profits, with the following result:

	A	B	C
Goodwill (at 20%)	$ 30,000	$ 30,000	$120,000

Other rates would, of course, produce other results.

Case 4.—Each of the three foregoing cases results in according like treatment to companies A and B. Even a casual inspection of the reported earnings of these companies raises a question as to which is the "better buy." Company A's earnings have increased with each passing year. Those of Company B have decreased steadily except for a slight improvement in 1931 over the results of 1930. It seems reasonable to conclude that Company A has better prospects than has Company B. In 1932, on the same net-asset investment, Company A's earnings were more than double those of Company B. Recognition of these facts may prompt the directors to use the earnings of three years instead of five as a basis of calculation, or to weight the earnings of each year in a manner designed to favor the company whose profit *trend* is most favorable or to adopt some other modification of the plan described.

It may be that the method of capitalizing excess profits will be abandoned in favor of the method of purchasing excess profits. In the application of this method there is, likewise, room for bargaining.

The new company may purchase: (1) the excess profits over a given number of years or (2) a number of times the average excess profits over a given number of years. Obviously in the case of the Companies A, B, and C, the average profits over five years do not accurately reflect the relative earning powers of Companies A and B. The decision may favor allowing goodwill equal to five times the average excess profit of the last three years. The calculation is as follows:

	A	B	C
Profits last three years	$110,000	$ 75,000	$214,000
Average	$ 36,667	$ 25,000	$ 71,333
Less 12% on net assets	24,000	24,000	48,000
Average excess	$ 12,667	$ 1,000	$ 23,333
Goodwill (5×average)	$ 63,333	$ 5,000	$116,667

Case 5.—More arbitrarily, goodwill may be regarded as equal to: (1) a given number of times the last year's *total* net profit, or (2) to the net profits of the last two (three or more) years. For example:

	A	B	C
Goodwill equal to:			
3×profit of last year	$135,000	$ 60,000	$189,000
Net profit of last 2 years	80,000	50,000	154,000

15. Illustration of a Holding Company.—In Art. 10, Illustration 5, appear the balance sheets of Companies A, B, and C, and, in Illustration 6, the balance sheet of Company A following the merger of the three companies. Instead of merging the companies, it may be desirable for Company A to secure control of Companies B and C by acquiring the voting stock of these companies. It is assumed, there-

COMPANY A
BALANCE SHEET
December 31, 1932

Assets			
Current Assets:			
Cash		$ 15,000	
Receivables	$25,000		
Less Bad Debts Reserve	1,000	24,000	
Inventories		30,000	
Total Current Assets			$ 69,000
Fixed Assets:			
Fixtures	$ 8,000		
Buildings	20,000		
	$28,000		
Less Depreciation Reserve	3,000	$ 25,000	
Land		10,000	
Total Fixed Assets			35,000
Investments in Other Companies:			
Company B (100% at Cost)		$ 57,900	
Company C (100% at Cost)		57,800	
Total Investments			115,700
Deferred Charges			1,000
Total Assets			$220,700
Liabilities and Capital			
Current Payables			$ 20,000
Capital:			
Common Stock Issued		$190,700	
Surplus		6,000	
Land Appraisal Surplus		4,000	
Total Net Worth			200,700
Total Liabilities and Capital			$220,700

ILLUSTRATION 9

fore, that Company A secures 100-per-cent. ownership of the stocks of Companies B and C by issuing directly to the *stockholders* of the latter companies \$57,900 and \$57,800 respectively of Company A common stock. To determine the financial position of the *holding company*, Company A, it is necessary to prepare only the customary balance sheet, Illustration 9.

WORKING PAPERS

	Trial Balances			Eliminations	Consolidated Balance Sheet
	Company A	Company B	Company C		
Cash	15,000	10,000	2,000	. . . .	27,000
Receivables	25,000	35,000	15,000	. . . .	75,000
Inventories	30,000	20,000	30,000	. . . .	80,000
Fixtures	8,000	4,000	5,000	. . . .	17,000
Plant and Equipment	. . .	65,000	50,000	. . . .	115,000
Buildings	20,000	. . .	. . .	. . .	20,000
Land	10,000	10,000	10,000	. . .	30,000
Deferred Charges	1,000	3,000	4,000	. . .	8,000
Investment in Co. B	57,900	. . .	. . .	. . .	. . .
Eliminate:					
100% Capital Stock	. . .	. . .	. . .	25,000	. . .
100% Surplus	. . .	. . .	. . .	16,000	. . .
Goodwill	. . .	. . .	. . .	. . .	16,900*G*
Investment in Co. C	57,800	. . .	. . .	. . .	. . .
Eliminate:					
100% Capital Stock	. . .	. . .	. . .	60,000	. . .
100% Surplus	. . .	. . .	. . .	31,000	. . .
Goodwill	. . .	. . .	. . .	. . .	33,200**G*
Goodwill	. . .	. . .	25,000	. . .	25,000 *G*
	224,700	147,000	141,000	132,000	380,700
Current Payables	20,000	25,000	15,000	. . .	60,000
Reserve for Bad Debts	1,000	1,000	. . .	. . .	2,000
Reserve for Depreciation	3,000	30,000	10,000	. . .	43,000
Bonds Payable	. . .	50,000	25,000	. . .	75,000
Capital Stock:					
Company A	190,700	. . .	. . .	. . .	190,700
Company B	. . .	25,000			. . .
Eliminate	. . .	. . .	. . .	25,000	. . .
Company C	. . .	. . .	60,000		. . .
Eliminate	. . .	. . .	. . .	60,000	. . .
Surplus:					
Company A	6,000	. . .	. . .	. . .	6,000*S*
Land Appraisal	4,000	. . .	. . .	. . .	4,000*S*
Company B	. . .	16,000	. . .		. . .
Eliminate Acquired	. . .	. . .	. . .	16,000	. . .
Company C	. . .	. . .	31,000		. . .
Eliminate Acquired	. . .	. . .	. . .	31,000	. . .
	224,700	147,000	141,000	132,000	380,700

*Negative goodwill. In this and the following Working Papers *G* indicates Goodwill, and *S* indicates Surplus.

ILLUSTRATION 10

An inspection of the balance sheet, Illustration 9, reveals immediately the fact that little can be known of Company A's strength unless one has complete information concerning the wholly-owned subsidiaries, B and C. For this reason, the balance sheet of a holding company is seldom, if ever, of value. In its stead accountants prepare the balance sheet of the *consolidation* or, as it is usually termed, the Consolidated Balance Sheet of Company A, and Subsidiary Companies B and C. To prepare this statement, one first prepares consolidated *working papers* from the trial balances of the respective companies and from certain additional data. In this manner, like items among assets (and liabilities) are combined, but investments in subsidiaries owned are *eliminated* against the capital stock and surplus accounts of the subsidiary companies.

In Illustration 10 are shown the working papers applicable to the three companies mentioned at the date of acquisition of the control, and in Illustration 11 the consolidated balance sheet.

COMPANY A AND SUBSIDIARIES B AND C

CONSOLIDATED BALANCE SHEET

December 31, 1932

Assets			
Cash		\$ 27,000	
Receivables	\$ 75,000		
Less Reserve for Bad Debts	2,000	73,000	
Inventories		80,000	
Total Current Assets			\$180,000
Fixtures	\$ 17,000		
Plant and Equipment	115,000		
Buildings	20,000		
	\$152,000		
Less Depreciation Reserve	43,000	\$109,000	
Land		30,000	
Total Fixed Assets			139,000
Deferred Charges			8,000
Goodwill			8,700
Total Assets			\$335,700
Liabilities and Capital			
Current Payables			\$ 60,000
Bonds Payable			75,000
Net Worth:			
Capital Stock		\$190,700	
Surplus		6,000	
Land Appraisal Surplus		4,000	
Total Net Worth			200,700
Total Liabilities and Capital			\$335,700

ILLUSTRATION 11

Comments:

Careful study should be made of the three balance sheets, Illustrations 6, 9, and 11.

(1) Almost the only figure that remains constant is the net worth.

(2) The consolidated balance sheet, Illustration 11, yields more information than is obtainable from the balance sheet of the holding company, Illustration 9.

(3) In view of the adjustments made prior to the *merger* of Companies B and C with Company A, the asset valuations in the consolidated statement, Illustration 11, are less accurate than those in the balance sheet, Illustration 6, prepared immediately after the merger. This situation prevails because the new values accepted in the merger cannot be incorporated into the records of the *subsidiary companies* until Company A, through its stock ownership, *formally* substitutes directors of its own choosing for those serving at present. Once these changes are introduced, the details of the consolidated statement, Illustration 11, will be exactly the same as those appearing on the merger statement, Illustration 6.

(4) It should be noted that the liabilities of the merger, as given in Illustration 6 are exactly those of the consolidation, Illustration 11.

(5) In the balance sheet, Illustration 11, appears goodwill of $8,700. It will be noticed that three goodwill values appear in the consolidated working papers and that this balance sheet value is obtained by combining the working-paper values. An alternative balance sheet presentation is possible. Among the assets may be exhibited goodwill of $41,900 if a capital surplus of $33,200 is shown in the net-worth section. The author's method of showing only the net amount is unquestionably that favored by most accountants. It appears to be a more conservative method. It is true, however, that the more conservative method is not always the better method. If one buys a company (or a controlling interest therein) and pays more than the value of the net assets, it is usually assumed that a payment for *goodwill* has been made. But if the buyer pays less than the value of the net assets he has made a saving of the difference between the price paid and the value of the net assets. This saving is referred to, particularly in the case of a holding corporation, as *negative goodwill*. As is not infrequently the case in recording savings, a saving of this type may be expressed as a *capital surplus* item. If positive goodwill appears in the consolidated working papers, the negative goodwill may (1) be used to reduce the positive goodwill in the consolidated balance sheet or (2) be exhibited as capital surplus, with a corresponding increase in the amount of exhibited positive goodwill over the amount shown under (1). If no positive goodwill appears in the working papers, the negative goodwill is shown in the consolidated balance sheet as a capital surplus item. It is possible, of course, that the negative goodwill may exceed the positive goodwill in amount. In such case, the same alternatives prevail: (1) the amounts may be combined and the difference shown as capital surplus, or (2) each type may be exhibited separately. As is indicated in Art. 16, the balance sheet should be prepared in the manner that most adequately reveals the financial facts at the time of its preparation.

QUESTIONS AND PROBLEMS

Answers and solutions to the following questions and problems are now to be prepared by you after careful study of the foregoing chapter. Any good quality of paper on which your work will appear neat and legible may be used.

(1) What is the difference between a *merger* and a *consolidation?*

(2) What constitutes a *controlling interest* in a corporation?

(3) Explain why some alteration of book values is usually necessary before a merger or consolidation can take place. Illustrate your answer.

(4) What is the difference between the balance sheet of a holding company and a consolidated balance sheet?

(5) What is "negative goodwill" and how should it appear on a consolidated balance sheet?

(6) The Coasting Company was organized on March 1, 19—, with an authorized capital of 1,000 shares of preferred stock of $100 par value and 5,000 shares of common stock without par value. One thousand shares of the common stock were issued to the incorporators for $15,000 in cash. One-half of the preferred stock was subscribed at par and a 50-per-cent. cash payment was made on the subscription, the balance to be paid on June 1.

On March 31, the Coasting Company agreed to purchase the assets and to assume the liabilities of the Racing Company. The balance sheet of the latter company appeared as follows on that date.

RACING COMPANY
Balance Sheet, March 31, 19—

Assets		*Liabilities and Capital*	
Current	$ 30,000	Liabilities	$ 20,000
Fixed	100,000	Capital Stock	100,000
Goodwill and Intangibles	10,000	Surplus	20,000
	$140,000		$140,000

The agreement between the two companies was as follows:

(1) The Coasting Company shall take over all assets and liabilities except the goodwill and intangibles.

(2) Payment shall be made to the Racing Company in 3,000 shares of common stock and 500 shares of preferred stock, the latter at a premium of 12 points.

On this basis the exchange was made on April 1.

You are asked to submit: (1) All journal entries on the books of the Coasting Company. (2) A balance sheet of the Coasting Company as of April 1.

Retain your answers and solutions and continue with the study of the next chapter.

CHAPTER III

CONSOLIDATED BALANCE SHEETS AT ACQUISITION DATE AND AFTER ACQUISITION DATE

16. Consolidated Balance Sheet at Date of Acquisition.—As has already been indicated, the consolidated balance sheet is designed to reveal the combined financial positions of the parent company and its subsidiaries. In general, two points of major significance present themselves: (1) all duplications must be eliminated and (2) the non-consolidated interest must be set apart by itself. The

A, B, C, AND D
BALANCE SHEETS

	A	B	C	D
Cash	$800,000	$ 20,000	$ 25,000	$ 30,000
Other Assets	100,000	150,000	280,000	400,000
	$900,000	$170,000	$305,000	$430,000
Liabilities	....	$ 20,000	$ 55,000	$ 70,000
Capital Stock	$900,000	150,000	200,000	400,000
Surplus	....	....	50,000	40,000*
	$900,000	$170,000	$305,000	$430,000

*Deficit.

ILLUSTRATION 12

second point arises if any subsidiary company is not one hundred per cent. owned by the holding company. If the holding company owns (or controls) less than a controlling interest in another company, that company is not, strictly speaking, a subsidiary company and the investment of the holding company is not eliminated against the offsetting net-worth accounts of the partly owned company. Instead, the holding company's investment is carried, usually at cost price, as an asset on the consolidated balance sheet.

In purchasing an interest in a subsidiary company, the holding company may pay book value, less than book value, or more than book value. The subsidiary may have a surplus, or a deficit or neither surplus nor deficit. In any case, the consolidated working papers are used to eliminate that part of the investment (of the holding company) which is equal to the book value (according to the books of the subsidiary) acquired through the investment. If the eliminated book value is less than the investment, the balance is carried to the consolidated balance sheet column as *positive goodwill*. If, on the other hand, the eliminated book value

exceeds the investment, the excess is carried as *negative goodwill*, or as *capital surplus*. Examples will be used to clarify these statements. Only working papers are given in a majority of the cases. It should be understood that the consolidated balance sheet is prepared from the right-hand column of the working papers. The illustrative working papers that follow are based on the balance sheets shown in Illustration 12.

The procedures in cases of acquisitions at different values are illustrated in the following five cases:

Case 1: Acquisitions at Book Value.—

Company A buys a 100 per cent. interest in Company B, 80 per cent. in Company C, and 90 per cent. in Company D.

Case 2: Acquisitions at Prices Above Book Value.—

Company A buys interests:

100 per cent. in Company B for $175,000
80 per cent. in Company C for $220,000
90 per cent. in Company D for $330,000

Case 3: Acquisitions at Prices Below Book Value.—

Company A buys interests:

100 per cent. in Company B for $135,000
80 per cent. in Company C for $180,000
90 per cent. in Company D for $300,000

Case 4: Acquisitions at More than Book Value, Less than Book Value and Book Value.—

Company A buys interests:

80 per cent. in Company B for $150,000
90 per cent. in Company C for $200,000
100 per cent. in Company D for $360,000

Case 5: Company A Buys Interests.—

60 per cent. in Company B for $ 80,000
75 per cent. in Company C for $202,500
25 per cent. in Company D for $100,000

In the working papers which follow several methods of eliminating the holding company's interest are shown. No one method is best in all cases.

CASE 1. CONSOLIDATED WORKING PAPERS

	Company A	Company B	Company C	Company D	Eliminations	Consolidated Balance Sheet
Cash	126,000	20,000	25,000	30,000		201,000
Other Assets	100,000	150,000	280,000	400,000		930,000
Investments:						
Stock of Company B, 100%	150,000					
Eliminate					150,000	
Stock of Company C, 80%	200,000					
Eliminate						
80% of $200,000					160,000	
80% of $50,000					40,000	
Stock of Company D, 90%	324,000					
Eliminate						
90% of $360,000					324,000	
Deficit:						
Company D				40,000		
Eliminate 90%					36,000	
Minority Share						4,000*M*
	900,000	170,000	305,000	470,000	710,000	1,135,000
Liabilities		20,000	55,000	70,000		145,000
Capital Stock:						
Company A	900,000					900,000
Company B		150,000				
Eliminate					150,000	
Company C			200,000			
Eliminate 80%					160,000	
Minority Share						40,000*M*
Company D				400,000		
Eliminate 90%					360,000	
Minority Share						40,000*M*
Surplus:						
Company C			50,000			
Eliminate 80%					40,000	
Minority Share						10,000*M*
	900,000	170,000	305,000	470,000	710,000	1,135,000

Illustration 13

The following Schedule of Minority Interests is prepared from data shown in Illustration 13, Consolidated Working Papers for Case 1. The Consolidated Balance Sheet for the same case is shown in Illustration 14.

Schedule of Minority Interests

	Total	Company C	Company D
Capital Stock	$80,000	$40,000	$40,000
Surplus	6,000	10,000	4,000*
	$86,000	$50,000	$36,000

*Deficit.

COMPANY A AND SUBSIDIARY COMPANIES B, C, AND D
Consolidated Balance Sheet

Assets		*Liabilities and Capital*	
Cash	$ 201,000	Liabilities	$ 145,000
Other Assets	930,000	Minority Interest (See Schedule)	86,000
		Capital Stock	900,000
	$1,131,000		$1,131,000

Illustration 14

CASE 2. CONSOLIDATED WORKING PAPERS

	Company A	Company B	Company C	Company D	Eliminations	Consolidated Balance Sheet
Cash	75,000	20,000	25,000	30,000		150,000
Other Assets	100,000	150,000	280,000	400,000		930,000
Investments:						
Stock of Company B, 100%	175,000					
Eliminate					150,000	
Goodwill						25,000*G*
Stock of Company C, 80%	220,000					
Eliminate:						
80% of $200,000					160,000	
80% of $50,000					40,000	
Goodwill						20,000*G*
Stock of Company D, 90%	330,000					
Eliminate						
90% of $360,000					324,000	
Goodwill						6,000*G*
Deficit:						
Company D				40,000		
Eliminate 90%					36,000	
Minority Interest						4,000*M*
	900,000	170,000	305,000	470,000	710,000	1,135,000
Liabilities		20,000	55,000	70,000		145,000
Capital Stock:						
Company A	900,000					900,000
Company B		150,000				
Eliminate					150,000	
Company C			200,000			
Eliminate 80%					160,000	
Minority Interest						40,000*M*
Company D				400,000		
Eliminate 90%					360,000	
Minority Interest						40,000*M*
Surplus:						
Company C			50,000			
Eliminate 80%					40,000	
Minority Interest						10,000*M*
	900,000	170,000	305,000	470,000	710,000	1,135,000

Illustration 15

Comments:

1. The eliminations in Cases 1, 2, and 3, Illustrations 13, 15, and 16, are identical in amount. It should be understood that the net worth acquired (and hence, to be eliminated) depends not on the price paid but on the number of shares bought.

2. The dollar sign ($) seldom appears in working papers because the ruling of the analysis sheet is indicative of a dollars and cents presentation.

3. For Cases 3 and 4, the working papers, Illustrations 16 and 17, are confined to the investment and net worth items.

4. The working papers for Case 5 are shown in Illustration 18.

CASE 3. CONSOLIDATED WORKING PAPERS (PARTIAL)

	Company A	Company B	Company C	Company D	Eliminations	Consolidated Balance Sheet
Investments:						
Stock of Company B, 100%	135,000					
Eliminate					150,000	
Goodwill						15,000*G
Stock of Company C, 80%	180,000					
Eliminate:						
80% of $200,000					160,000	
80% of $50,000					40,000	
Goodwill						20,000*G
Stock of Company D, 90%	300,000					
Eliminate:						
90% of $360,000					324,000	
Goodwill						24,000*G
					674,000	
Capital Stock:						
Company A	900,000					900,000
Company B		150,000				
Eliminate					150,000	
Company C			200,000			
Eliminate 80%					160,000	
Minority Share						40,000*M*
Company D				400,000		
Eliminate 90%					360,000	
Minority Share						40,000*M*
Surplus:						
Company C			50,000			
Eliminate 80%					40,000	
Minority Share						10,000*M*
Company D, Deficit				40,000†		
Eliminate 90%					36,000†	
Minority Share						4,000†*M*
					674,000	

*Negative Goodwill. †Deficit.

ILLUSTRATION 16

CASE 4. CONSOLIDATED WORKING PAPERS (PARTIAL)

	Company A	Company B	Company C	Company D	Eliminations	Consolidated Balance Sheet
Investments:						
Stock of Company B, 80%	150,000					
Eliminate:						
80% of $150,000					120,000	
Goodwill						30,000*G*
Stock of Company C, 90%	200,000					
Eliminate:						
90% of $200,000					180,000	
90% of $50,000					45,000	
Goodwill						25,000*G
Stock of Company D, 100%	360,000					
Eliminate					360,000	
					705,000	
Capital Stock:						
Company A	900,000					900,000
Company B		150,000				
Eliminate 80%					120,000	
Minority Share						30,000*M*
Company C			200,000			
Eliminate 90%					180,000	
Minority Share						20,000*M*
Company D				400,000		
Eliminate 100%					400,000	
Surplus:						
Company C			50,000			
Eliminate 90%					45,000	
Minority Share						5,000*M*
Company D, Deficit				40,000†		
Eliminate 100%					40,000†	
					705,000	

*Negative Goodwill. †Deficit.

ILLUSTRATION 17

The Consolidated Balance Sheet prepared from data in Illustration 18 is shown in Illustration 19. The Schedule of Minority Interests is as follows:

SCHEDULE OF MINORITY INTERESTS

	TOTAL	COMPANY B	COMPANY C
Capital Stock	$110,000	$60,000	$50,000
Surplus	12,500		12,500
	$122,500	$60,000	$62,500

Comment: In the balance sheet, Illustration 19, the $10,000 of negative goodwill on the consolidated working papers is shown as Capital Surplus. The balance sheet may be altered by showing only $5,000 of Goodwill and eliminating the $10,000 of Capital Surplus. Many accountants would advise this on the ground that it is "more conservative." There seems to be, however, a growing belief

among leading accountants that conservatism *alone* is poor ground on which to base many practices that have been upheld in the past. If $15,000 is the proper value of the goodwill acquired through the purchase of stock in Company C, it should be shown. It is quite possible that Company A made a fortunate deal in acquiring Company B stock at less than book value. In such case, the $10,000

CASE 5. CONSOLIDATED WORKING PAPERS

	Company A	Company B	Company C	Eliminations	Consolidated Balance Sheet
Cash	417,500	20,000	25,000		462,500
Other Assets	100,000	150,000	280,000		530,000
Investments:					
Stock of Company B, 60%	80,000				
Eliminate:					
60% of $150,000				90,000	10,000*G
Stock of Company C, 75%	202,500				
Eliminate:					
75% of $200,000				150,000	
75% of $50,000				37,500	
Goodwill					15,000G
Stock of Company D, 25%	100,000				100,000
	900,000	170,000	305,000	277,500	1,097,500
Liabilities		20,000	55,000		75,000
Capital Stock:					
Company A	900,000				900,000
Company B		150,000			
Eliminate 60%				90,000	
Minority Interest					60,000M
Company C			200,000		
Eliminate 75%				150,000	
Minority Interest					50,000M
Surplus:					
Company C			50,000		
Eliminate 75%				37,500	
Minority Interest					12,500M
	900,000	170,000	305,000	277,500	1,097,500

*Negative Goodwill.

ILLUSTRATION 18

COMPANY A AND SUBSIDIARY COMPANIES B AND C

CONSOLIDATED BALANCE SHEET

Assets		*Liabilities and Capital*	
Cash	$ 462,500	Liabilities	$ 75,000
Other Assets	530,000	Minority Interest (See Schedule)	122,500
Investments	100,000	Capital Stock	900,000
Goodwill	15,000	Capital Surplus	10,000
	$1,107,500		$1,107,500

ILLUSTRATION 19

"benefit" should not be offset against goodwill but should appear as shown in the balance sheet, Illustration 19. It is the accountant's *first duty to prepare statements and reports that reflect the actual facts.*

17. Consolidated Balance Sheet After Date of Acquisition—Investment Carried at Cost.—It has been pointed out that the preparation of consolidated working papers at the date the holding company acquires its interest in the subsidiary company requires the eliminating of *that part of the subsidiary's net worth which is acquired by the holding company.* In preparing subsequent working papers, either of two procedures may be followed. If the holding company continues to carry its investment *at cost*, the elimination is always the same as that made in the original instance, *at date of acquisition.* If the holding company *takes up periodically its share of the subsidiary's losses and gains*, the elimination will be based, not on the book values existing at date of acquisition, but on the book value of the subsidiary *on the date of the preparation of the consolidated balance sheet.*

In the illustrations that follow it is assumed that the holding company, Company A, continues its investments at cost. These working papers are based on Case 5 in the preceding article. One year after the acquisition of the holding company's interests, the balance sheets of Companies A, B, and C appear as in Illustration 20.

A, B, AND C

BALANCE SHEETS

	Company A	Company B	Company C
Cash	$ 94,000	$ 45,000	$ 65,000
Other Assets	105,000	160,000	255,000
Dividends Receivable	32,000		
U. S. Securities	350,000		
Investment in Company B	80,000		
Investment in Company C	202,500		
Investment in Company D	100,000		
	$963,500	$205,000	$320,000
Liabilities	$ 15,000	$ 25,000	$ 50,000
Dividends Payable			40,000
Capital Stock	900,000	150,000	200,000
Surplus	48,500	30,000	30,000
	$963,500	$205,000	$320,000

ILLUSTRATION 20

On December 15, Company D declared a 2-per-cent. dividend, payable January 10 to stockholders of record December 31.

On the same day Company C declared a 20-per-cent. dividend, payable January 5 to stockholders of record December 24.

The consolidated working papers are shown in Illustration 21, and the Consolidated Balance Sheet in Illustration 22.

COMPANY A AND SUBSIDIARY COMPANIES B AND C

CONSOLIDATED WORKING PAPERS

December 31, 19—

	Company A	Company B	Company C	Eliminations	Consolidated Balance Sheet
Cash	94,000	45,000	65,000		204,000
Other Assets	105,000	160,000	255,000		520,000
Dividends Receivable	32,000				
Eliminate				30,000	2,000
U. S. Securities	350,000				350,000
Investments:					
Stock of Company B, 60%	80,000				
Eliminate Book Value Acquired, 60% of $150,000				90,000	
Goodwill					10,000*G
Stock of Company C, 75%	202,500				
Eliminate Book Value Acquired, 75% of $250,000				187,500	15,000G
Stock of Company D, 25%	100,000				100,000
	963,500	205,000	320,000	307,500	1,181,000
Liabilities	15,000	25,000	50,000		90,000
Dividends Payable			40,000		
Eliminate				30,000	10,000
Capital Stock:					
Company A	900,000				900,000
Company B		150,000			
Eliminate 60%				90,000	
Minority Interest 40%					60,000M
Company C			200,000		
Eliminate 75%				150,000	
Minority Interest 25%					50,000M
Surplus:					
Company A	48,500				48,500S
Company B		30,000			
Minority Interest 40%					12,000M
Consolidate					18,000S
Company C			30,000		
Eliminate 75% of $50,000				37,500	
Minority Interest 25%					7,500M
Consolidate					15,000†S
	963,500	205,000	320,000	307,500	1,181,000

*Negative Goodwill. †Deficit.

ILLUSTRATION 21

Comments:

(1) Note the alternative showing of the minority interests.

(2) Note that intercompany dividends receivable and payable do not appear on the balance sheet. This is in full accord with the purpose of the consolidated balance sheet, which is to exhibit the position of the *consolidated interests* as distinct from all other interests. The fact should be recognized that the payment of a

COMPANY A AND SUBSIDIARY COMPANIES B AND C

CONSOLIDATED BALANCE SHEET

Assets		*Liabilities and Capital*		
Cash	$ 204,000	Other Liabilities		$ 90,000
Other Assets	520,000	Dividends Payable		10,000
Dividends Receivable	2,000	Minority Interests:		
U. S. Securities	350,000	Company B	$72,000	
Investments	100,000	Company C	57,500	129,500
Goodwill	15,000			
		Capital Stock		900,000
		Surplus:		
		Capital	$10,000	
		Earned	51,500	61,500
	$1,191,000			$1,191,000

ILLUSTRATION 22

$40,000 dividend by Company C will remove only $10,000 in cash from the *consolidation.*

(3) The consolidated earned surplus may be exhibited as follows:

	EARNINGS	COMPANY A's SHARE	MINORITY SHARE
Balance Jan. 1, Company C	$ 50,000	$ 37,500	$12,500
Net Profit per Books:			
Company A	48,500	48,500	
Company B	30,000	18,000	12,000
Company C	20,000	15,000	5,000
Total	$148,500	$119,000	$29,500
Purchased Surplus, Co. C	37,500	37,500	
Balance	$111,000	$ 81,500	$29,500
Dividend Declared, Co. C	40,000	30,000	10,000
Balance, December 31	$ 71,000	$ 51,500	$19,500

If one or more of the subsidiary companies sustains a loss during the year, no change occurs in the principles upon which the accountant bases his elimination of the investment accounts against the subsidiaries' net-worth accounts. The following illustration is based on the same balance sheets of Companies A, B, and C as the foregoing, except that Company B's balance sheet is assumed to show: Cash $15,000; Other Assets $145,000; and Deficit $15,000. The working paper eliminations for the investment in Company B would appear as in Illustration 23.

None of the deficit is eliminated because Company B had neither surplus nor deficit at the date at which Company A acquired its interest.

CONSOLIDATED WORKING PAPERS

	Company A	Company B	Eliminations	Consolidated Balance Sheet
Investment in Company B, 60%	80,000			
Eliminate 60% of $150,000 book value			90,000	10,000*G
Capital Stock:				
Company B		150,000		
Eliminate 60%			90,000	
Minority Interest 40%				60,000M
Surplus:				
Company B, Deficit		15,000†		
Minority Interest 40%				6,000†M
Consolidate				9,000†S

*Negative Goodwill. †Deficit.

ILLUSTRATION 23

COMPANIES H, X, AND Y
CONSOLIDATED WORKING PAPERS

	Company H	Company X	Company Y	Eliminations	Consolidated Balance Sheet
Investment in Company X, 80%	120,000				
Eliminate					
80% of Capital Stock				80,000	
Surplus				40,000	
Investment in Company Y, 70%	168,000				
Eliminate Book Value Acquired				168,000	
				288,000	
Capital Stock:					
Company X		100,000			
Eliminate 80%				80,000	20,000M
Company Y			300,000		
Eliminate 70%				210,000	90,000M
Surplus:					
Company X		20,000			
Eliminate Acquired 80% of $50,000				40,000	
Minority, 20% of $20,000					4,000M
Consolidate Company H's share of $30,000 loss					24,000*S
Company Y, Deficit			100,000*		
Eliminate Acquired 70% of $60,000 Deficit				42,000*	
Minority, 30% of $100,000					30,000*M
Consolidate Company H's share of $40,000 Loss					28,000*S
				288,000	

*Deficit.

ILLUSTRATION 24

The following will serve to illustrate the working-paper eliminations following losses by the subsidiary, if (1) a surplus and (2) a deficit existed at date of the acquiring of the parent company's interest: On July 1, 1932, Company H acquired at book value an 80-per-cent. interest in Company X and a 70-per-cent. interest in Company Y. At that date, the balance sheets of the subsidiary companies revealed:

	COMPANY X	COMPANY Y
Capital Stock	$100,000	$300,000
Surplus	50,000	
Deficit		60,000
Net Worth	$150,000	$240,000

During the year, Company X lost $30,000 and Company Y lost $40,000.

In Illustration 24 are shown consolidated working papers setting forth the situation on June 30, 1933, it being assumed that no dividends have been declared.

18. Consolidated Balance Sheet After Date of Acquisition—Investment Adjusted for Losses and Gains.—The holding company's investment in the stock of its subsidiary represents a definite percentage of the net worth of the subsidiary. If, for example, the holding company owns 80 per cent. of the stock of the subsidiary, it follows that the holding company is entitled to 80 per cent. of the subsidiary's profits and will receive this percentage of the subsidiary's dividends. Since losses are negative profits, it follows that the holding company will sustain 80 per cent. of the subsidiary's losses.

It is wholly unlikely that the net worth of the subsidiary will long approximate that existing at the date of the holding company's acquiring an interest. Few corporations stand still financially; they must go either forward or backward. Few corporations pay out in dividends the entire earnings of each year.

From these facts, one may surmise that the actual value of the holding company's interest in the subsidiary will fluctuate with the fortunes of the subsidiary. The subsidiary's earnings increase the value of the holding company's investment because the existence of earnings probably foretells the payment of dividends. The receipt of a dividend, on the contrary, lessens the value of the investment because the fact that the dividend has been paid converts a part of the investment into cash of the holding company. Losses of the subsidiary, like dividends, lessen the value of the investment, but, unlike dividends, result in no conversion into cash. The original cost of the investment may be valuable for historical purposes but it is seldom a measure of the current value of the investment from year to year. The value of the investment is best determined by taking, at any given balance sheet date, the holding company's percentage of the net worth *as revealed by the books of the subsidiary*.

In order that the investment account of the holding Company H may record the fluctuations in the value of the investment, the following

entries are made annually (or more frequently) as the subsidiaries determines profits or losses and declare dividends.

Investment in Stock of Company S . . .	$16,000	
Profit and Loss from Subsidiaries . .		$16,000
To take up 80-per-cent. share of Company S's $20,000 profit.		
Profit and Loss from Subsidiaries	17,000	
Investment in Stock of Company X .		17,000
To take up 85-per-cent. share of Company X's $20,000 loss.		
Dividends Receivable	12,000	
Investment in Stock of Company S .		12,000
For Company H's share of $15,000 dividend declared today by Company S.		
Cash	10,000	
Investment in Stock of Company Y . .		10,000
For 100 per cent. of the dividend declared and paid today by Company Y.		

Illustrative Case:

The following illustrative case is based on the balance sheets and other data given at the beginning of Art. 17. The balance sheet of Company A, the parent company, as shown in Illustration 25, is prepared just prior to the taking up of the holding company's shares of the subsidiaries' gain. The value of the investment in the Stock of Company C has been reduced for Company A's share of dividends declared by Company C payable January 5.

COMPANY A

BALANCE SHEET

December 31, 19—

Assets		*Liabilities and Capital*	
Cash	$ 94,000	Liabilities	$ 15,000
Other Assets	105,000	Capital Stock.	900,000
Dividends Receivable	32,000	Surplus	18,500
U. S. Securities	350,000		
Investments:			
Stock of Company B . . .	80,000		
Stock of Company C . . .	172,500		
Stock of Company D . . .	100,000		
	$933,500		$933,500

ILLUSTRATION 25

When Company A learns the results of the year's operations of Companies B and C, the statement shown in Illustration 25 will be adjusted by the following entries. It is likely that Company A's books will be held open for the purpose of receiving these adjustments.

Investment in Company B	$18,000	
Investment in Company C	15,000	
Income from Subsidiaries		$33,000
To take up Company A's 60 per cent. of $30,000 profit of Company B and 75 per cent. of $20,000 profit of Company C.		
Income from Subsidiaries	$33,000	
Profit and Loss		$33,000
To close.		

COMPANIES A, B, AND C

CONSOLIDATED WORKING PAPERS

December 31, 19—

	Company A	Company B	Company C	Eliminations	Consolidated Balance Sheet
Cash	94,000	45,000	65,000	. . .	204,000
Other Assets	105,000	160,000	255,000	. . .	520,000
Dividends Receivable	32,000	. . .	. . .	. . .	. . .
Eliminate	. . .	. . .	. . .	30,000	2,000
U. S. Securities	350,000	. . .	. . .	. . .	350,000
Investments:					
Stock of Company B, 60%	98,000	. . .	. . .	. . .	. . .
Eliminate:					
60% of $150,000 Stock	. . .	. . .	. . .	90,000	. . .
60% of $30,000 Surplus . . .	. . .	. . .	. . .	18,000	. . .
Goodwill	. . .	. . .	. . .	. . .	10,000*G
Stock of Company C, 75%	187,500	. . .	. . .	. . .	. . .
Eliminate:					
75% of $200,000 Stock	. . .	. . .	. . .	150,000	. . .
75% of $30,000 Surplus . . .	. . .	. . .	. . .	22,500	. . .
Goodwill	. . .	. . .	. . .	. . .	15,000G
Stock of Company D, 25%	100,000	. . .	. . .	. . .	100,000
	966,500	205,000	320,000	310,500	1,181,000
Liabilities	15,000	25,000	50,000	. . .	90,000
Dividends Payable	. . .	. . .	40,000	. . .	. . .
Eliminate	. . .	. . .	. . .	30,000	10,000
Capital Stock:					
Company A	900,000	. . .	. . .	. . .	900,000
Company B	. . .	150,000	. . .	. . .	. . .
Eliminate 60%	. . .	. . .	. . .	90,000	. . .
Minority Interest 40%	. . .	. . .	. . .	. . .	60,000M
Company C	. . .	. . .	200,000	. . .	. . .
Eliminate 75%	. . .	. . .	. . .	150,000	. . .
Minority Interest 25%	. . .	. . .	. . .	. . .	50,000M
Surplus:					
Company A	51,500	. . .	. . .	. . .	51,500S
Company B	. . .	30,000	. . .	. . .	. . .
Eliminate 60%	. . .	. . .	. . .	18,000	. . .
Minority Interest 40%	. . .	. . .	. . .	. . .	12,000M
Company C	. . .	. . .	30,000	. . .	. . .
Eliminate 75%	. . .	. . .	. . .	22,500	. . .
Minority Interest 25%	. . .	. . .	. . .	. . .	7,500M
	966,500	205,000	320,000	310,500	1,181,000

*Negative Goodwill.

ILLUSTRATION 26

The balance sheets of the three companies may now be used as a basis for preparing consolidated working papers, as shown in Illustration 26. Because the holding company has taken up its share of the subsidiaries' profits, eliminations are based on the book values, not as of date of acquisition, but as of the current balance sheets of the subsidiaries.

COMPANIES H, X, AND Y
CONSOLIDATED WORKING PAPERS

	Company H	Company X	Company Y	Eliminations	Consolidated Balance Sheet
Investment in Company X, 80%	96,000				
Eliminate:					
80% of $100,000 Stock				80,000	
80% of $20,000 Surplus				16,000	
Investment in Company Y, 70%	140,000				
Eliminate:					
70% of $300,000 Stock				210,000	
70% of $100,000 Deficit				70,000*	
				236,000	
Capital Stock:					
Company X		100,000			
Eliminate 80%				80,000	
Minority Interest 20%					20,000M
Company Y			300,000		
Eliminate 70%				210,000	
Minority Interest 30%					90,000M
Surplus:					
Company X		20,000			
Eliminate 80%				16,000	
Minority Interest 20%					4,000M
Company Y, Deficit			100,000*		
Eliminate 70%				70,000*	
Minority Interest 30%					30,000*M
Company H, Deficit	52,000*				52,000*S
				236,000	

*Deficit.

ILLUSTRATION 27

As another illustration, consider the case of Companies H, X, and Y, discussed in connection with Illustration 24 in Art. 17.

If Company H carried its investments at "current value" instead of continuing them at cost value, the investment accounts would appear:

Investment in Stock of Company X

July 1, Cash	$120,000	June 30, Loss	$24,000

Investment in Stock of Company Y

July 1, Cash	$168,000	June 30, Loss	$28,000

The net worth and investment eliminations are shown in the consolidated working papers, Illustration 27.

PROBLEMS

Solutions to the following problems are now to be prepared by you after careful study of the foregoing chapter. Any good quality of paper on which your work will appear neat and legible may be used.

(1) Company A purchases 90 per cent. of the stock of Company X and 100 per cent. of the stock of Company Y. The following balance sheets indicate the condition of each company on the date of acquisition.

COMPANIES A, X, AND Y

BALANCE SHEETS

	Company A	*Company X*	*Company Y*
Investment in Company X	$480,000		
Investment in Company Y	180,000		
Current Assets	200,000	$515,642	$ 44,936
Fixed Assets	79,770	195,268	159,264
	$939,770	$710,910	$204,200
Current Liabilities	$159,310	$170,752	$ 30,996
Fixed Liabilities		20,000	
Capital Stock	700,000	400,000	150,000
Surplus	80,460	120,158	23,204
	$939,770	$710,910	$204,200

Prepare a consolidated balance sheet.

(2) On January 1, 19__, the Adams Corporation purchased all of the capital stock of the Brown Company at $175 per share and the entire capital stock of the Cable Company at $80 per share.

From the following balance sheets, representing the condition of the three companies on June 30, of the same year, prepare a consolidated balance sheet. Assume that the Adams Corporation will take up its share of the subsidiaries' gains before the consolidated statement is prepared.

ADAMS CORPORATION

BALANCE SHEET

Property	$ 850,000	Current Liabilities	$ 150,000
Stock of Subsidiary Companies	1,500,000	Capital Stock	2,250,000
Current Assets	700,000	Surplus, January 1	525,000
		Undivided Profits for half year	125,000
	$3,050,000		$3,050,000

BROWN COMPANY

BALANCE SHEET

Property	$650,000	Current Liabilities	$ 10,000
Current Assets	60,000	Capital Stock	400,000
		Surplus, January 1	200,000
		Undivided Profits for half year	100,000
	$710,000		$710,000

CABLE COMPANY

BALANCE SHEET

Property (as appraised January 1, 19—)	$1,130,000	Current Liabilities	$ 240,000
Current Assets	180,000	Capital Stock	1,000,000
		Surplus, January 1	30,000
		Undivided Profits for half year	40,000
	$1,310,000		$1,310,000

Look over your answers and solutions to the questions and problems following Chapters II and III and immediately send them to the Schools for correction.

CHAPTER IV

CONSOLIDATED BALANCE SHEETS, SPECIAL CONSIDERATIONS

19. Other Eliminations in Consolidated Working Papers.—The preceding Chapter has been devoted to an explanation of the procedure followed in offsetting the holding company's investment account balances against the net-worth accounts of the subsidiary companies. It is almost a certainty that, in preparing the working papers, the accountant will encounter other items that require elimination. The more common of such items will now be described.

Current Accounts.—If the subsidiary company sells to or purchases from the holding company it is likely that the trial balances will reveal intercompany accounts receivable and payable. Since transactions between the parties to the consolidation do not alter the relationship existing between the consolidation as a unit and outsiders, these current accounts should be eliminated in preparing the consolidated balance sheet. It occasionally happens that the account receivable on the books of one company is not the exact reciprocal of the account payable on the books of the other company. This will probably be the result of one of two causes: (1) the debtor has made a payment that has not yet been received by the creditor, or (2) the creditor has shipped merchandise to (or performed some other service for) the debtor which has not yet come to the latter's attention. In either case, the adjustment is made in the same "direction," that is, toward the completing of the transaction. The first case requires an entry adjusting the creditor's records debiting Cash in Transit and crediting the debtor. The second case necessitates the adjusting of the debtor's books by debiting Merchandise in Transit (or Inventory) and crediting the creditor. This principle governs, too, the adjusting of such inequalities as may be found in the reciprocal accounts described in the remainder of this Article.

Advances to Subsidiaries.—Not infrequently a weak subsidiary will be bolstered up by loans from the parent company. These advances are not, strictly speaking, current accounts though they may appear under this title. The current accounts should be restricted to amounts that are periodically settled within the customary credit terms. Amounts that are not expected to be settled in this manner should be shown as advances. They definitely increase the stake of the holding company in the subsidiary but do not alter the percentage of stock ownership. If the advance accounts have been properly handled they are likely to be true reciprocals. As such they are eliminated in the working papers.

Advances to the Holding Company.—Advances by a subsidiary Company to the holding company are merely the reverse of the advances just described. They are handled in a similar manner.

Notes Receivable and Payable.—Either the holding company or the subsidiary may give notes to the other. These are comparable to either current accounts or advance accounts, depending on the type of note given and the reason for giving it. The eliminations are made in the same way.

Notes Receivable Discounted.—If a note given by one member of the consolidation to another member of the consolidation reaches outsiders through being discounted by the member that received it, the consolidated balance sheet must reveal this liability to outsiders. This note is the liability of the issuing member and the contingent liability of the discounting member of the consolidation. It may be regarded also as the obligation of the consolidation *as a unit* to interests outside the consolidation. Alternative procedures have been suggested for eliminating intercompany items. It is suggested here that the Notes Receivable account balance should be eliminated against the Notes Receivable Discounted account balance and that the Notes Payable account balance should appear on the consolidated balance sheet.

Bonds Payable and Bonds Owned.—Bonds issued by one member and owned by another member offer no unusual problem. The intercompany holdings are eliminated at par value. If, in connection with these bonds, there is, on the books of either the issuing or the owning corporation, unamortized premium or unaccumulated discount, the premium and/or discount should be carried to the consolidated balance sheet column of the working papers. If the bonds were exchanged directly between the two members at some price other than par, and if both members have followed the same method of amortizing premium or accumulating discount, a definite amount of the premium (or discount) on the books of the owning corporation is a direct offset for a like amount of discount (or premium) on the books of the issuing corporation. In such case, there seems to be no valid objection to eliminating the premium (or discount) along with the par value. When the bonds have not passed directly from the issuing member to the owning member or when, even though the bonds passed directly, the two members have not followed the same method of writing off premium (or discount), no truly reciprocal relationship exists beyond that expressed by the par values in question. Under these conditions, it seems that little, if anything, of value is gained by attempting to adjust the books in such a way as to make these balances reciprocal. It seems preferable that the premium and discount amounts be shown on the consolidated balance sheet as already suggested.

Bond Interest Payable and Receivable.—Accrued interest on intercompany bond holdings should be handled in a uniform manner. Bond Interest Payable and Receivable, being true reciprocals, should be eliminated to the amount of the lesser item.

Dividends Payable and Receivable.—As dividends are declared by the subsidiary companies the amount payable to the parent company should be taken up on the latter's books as a receivable item. (See illustrative entries in Art. 18). These offsetting payables and receivables should be eliminated in the consolidated working papers.

20. Reserves for Intercompany Profits.—If one member of the consolidation sells to another member *at a profit*, this profit is not *realized by the consolidation* unless and until the purchasing member, in turn, sells the item for the same or a greater selling price to parties *outside* the consolidation. Intercompany sale-and-purchase transactions are likely to be one of two kinds: current assets (merchandise intended for resale) or fixed assets (buildings, equipment, etc. not intended for resale). No profit should be taken up by the consolidation as long as the article containing the profit is still an asset of the consolidation. An illustrative case may be used to clarify this statement. Assume that Company A owns 80 per cent. of the capital stock of Company B and that, at the end of the fiscal period, the inventory of Company A contains merchandise bought from Company B for $12,000, at which price Company B made a profit of $2,000. From the point of view of the minority interest in Company B, this is a completed transaction. From the point of view of the holding company, it is merely the transferring of merchandise "from one storeroom to another." The minority interest is entitled to 20 per cent. of this $2,000 profit, or $400. In taking up its share of Company B's profit, the parent company will take up the remaining 80 per cent. of this particular profit. Accordingly, it is essential that the holding company, in order that its realized profits be not overstated, set up a reserve for intercompany profits to the amount of $1,600. The reserve is established on the working papers by debiting the Surplus account of the holding company and crediting Reserve for Intercompany Profits on Inventories.

A similar situation arises if the sale is made from the parent company to a subsidiary. To reverse the preceding illustration it may be assumed that Company A has sold the merchandise in question to Company B. In doing so it actually sold 80 per cent. of the order to itself and only 20 per cent. to interests outside of the consolidation. Accordingly 80 per cent. of the $2,000 profit cannot be regarded as realized until Company B sells the merchandise to its customers outside the consolidation. The reserve to be created is set up in the same amount and by the same entry as described in the preceding paragraph.

Intercompany profits in fixed assets are treated in a somewhat similar manner. Assume that Company B (80-per-cent. owned by Company A) supplies Company A with certain fixed assets at a selling price of $80,000. The cost of this equipment to Company B was $60,000. Of the $20,000 profit made on this transaction, 80 per cent., or $16,000, will be taken up by Company A at the end of the fiscal year in which the sale occurred. In order that the assets may be shown on the consolidated balance sheet at cost price, Company A may handle the transaction in one of three ways, as follows:

1. No entry need be made in any ledger. With the preparation of each successive consolidated balance sheet during the life of the asset, a working-paper adjustment, debiting Surplus account and crediting the Reserve for Intercompany Profits on Equipment account, may be made for the $16,000. This permits a balance-sheet showing at cost. It should be pointed out that the minority profit is a proper part of cost price. On the books of Company A, the asset appears at $80,000. Depreciation should, however, be computed on cost. Assume a ten-year service life and an estimated scrap value of $10,000. Depreciation is,

accordingly, $\frac{1}{10}$ ($80,000 − $10,000 − $16,000) = $5,400 per annum. If the asset is written off after ten years and $10,000 is received in cash for scrap value the entry should be:

Cash	$10,000	
Reserve for Depreciation	54,000	
Surplus	16,000	
Equipment		$80,000

The debit to Surplus account removes from that account the unrealized profit taken up at the end of the year in which the equipment was acquired.

2. Company A may make a journal entry debiting Surplus account and crediting Equipment account for $16,000. This reduces the asset to a cost basis. This is probably the most satisfactory method.

3. Company A may handle this matter as in method 2 except for the fact that the credit may be passed to a Reserve for Intercompany Profit on Equipment Again, in this case, the annual depreciation should be $5,400 per annum. The reserve is carried until the asset is disposed of, and on the balance sheet appears as a deduction from the asset account, along with the deduction of the Reserve for Depreciation.

A slightly different situation arises if the holding company sells the equipment to a subsidiary. Assume, for illustrative purposes, that the transaction described is reversed. In selling to Company B at a profit of $20,000, Company A has in substance made 80 per cent. of this profit by selling to itself. Accordingly, a reserve should be set up for $16,000 in order that the consolidated balance sheet may exhibit the asset at cost. The asset will appear on the books of Company B at $80,000, and depreciation will be computed by Company B as $\frac{1}{10}$ ($80,000 − $10,000) = $7,000 per annum. This means that the consolidated net profits are *understated* (through excessive depreciation expense) to the amount of $1,600 per annum. As Company B makes sales, either directly or indirectly (through another member of the consolidation) to outsiders, depreciation charges of $70,000 are recovered. In this manner the $16,000 profit is gradually realized over the life of the asset. It is suggested that these facts are properly recorded if Company A establishes a reserve for $16,000 at the end of the fiscal year in which the sale occurs and then, at the end of each year of service life of the asset, reverses the entry for one-tenth of the original amount by debiting the reserve and crediting surplus account.

Another situation arises if one subsidiary sells equipment to another subsidiary. Assume that Company B (again 80-per-cent. owned by Company A) sells this equipment to Company C (60-per-cent. owned by Company A) at a profit of $20,000. Company A will take up at the end of the current fiscal year 80 per cent. of this profit in taking up its share of all profits made by Company B. Company C will set up the asset at $80,000 and, over the service life, will recover $70,000 through depreciation charges. Through this recovery, the intercompany profit is realized just as it was in the case previously cited. Therefore, it seems proper in this case to suggest the same treatment as indicated in the case of Company A's sale to Company B. The reserve should be set up initially by debiting Surplus account

and crediting the reserve account for $16,000. Each year subsequently for the next ten years, the entry should be reversed to the amount of $1,600.

Balance sheet presentations may be understood from the following:

One year after the sale:

Equipment		$80,000
Less Reserve for Depreciation	$ 7,000	
Reserve for Intercompany Profit	14,400	21,400
Carrying Value		$58,600

Two years after the sale:

Equipment		$80,000
Less Reserve for Depreciation	$14,000	
Reserve for Intercompany Profit	12,800	26,800
Carrying Value		$53,200

Nine years after the sale:

Equipment		$80,000
Less Reserve for Depreciation	$63,000	
Reserve for Intercompany Profit	1,600	64,600
Carrying Value		$15,400

21. Illustrative Case.—In Illustration 28 are given the December 31, 19__ balance sheets of Company H and its subsidiaries, Companies S-One and S-Two. Certain additional data essential to the preparation of a consolidated balance sheet are appended. The reader will gain most from this illustrative material if he makes notes concerning the working-paper disposition of each item in the balance sheets and additional data prior to continuing with the text. Better yet, he should prepare the working papers roughly and compare his work with that of the author, as shown in Illustration 29 (*a*) and (*b*).

Additional Data:

1. The investments of Company H are carried at cost. They represent an 80-per-cent. interest in Company S-One acquired at book value and a 90-per-cent. interest in Company S-Two acquired when that company had Capital Stock of $200,000 and Surplus of $30,000.

2. Company H has not yet received a check for $4,000 mailed December 29 by Company S-One.

3. The inventory of Company H lists at $30,000 goods received from Company S-Two on which the latter made a profit of $8,000. At the beginning of the year the inventory of Company H contained $20,000 worth of Company S-Two's product which had cost the subsidiary $15,000.

4. Of Company S-One's equipment, $100,000 worth was secured from Company H. This price included a profit of $22,500. This equipment was estimated to have a service life of ten years and a scrap value of $8,000. It is two years old.

5. Notes Receivable Discounted, of Company H, include a $12,000 note received from Company S-One.

6. Dividends Payable, of Company S-Two, represent a semiannual $4\frac{1}{2}$-per-cent. declaration of December 20, payable the following January 4, to stockholders of record December 31.

7. Bonds Payable bear interest:

Company H, 6 per cent., payable semiannually, April and October 1.
Company S-One, 5 per cent., payable annually, January 1.
Company S-Two. 6 per cent., payable semiannually January and July 1.

The Consolidated Working Papers for the foregoing problem are shown in Illustration 29 (*a*) and (*b*) and the Consolidated Balance Sheet in Illustration 30.

Balance Sheets
December 31, 19—

	Company H	Company S-One	Company S-Two
Assets			
Cash	$ 28,000	$ 31,850	$ 15,000
Accounts Receivable	40,000	30,000	20,000
Company S-One Current Account	30,000		
Company H Current Account			25,000
Notes Receivable, Company S-One	20,000		
Notes Receivable	18,000	14,000	12,000
Advances to Subsidiaries	50,000		
Advance to Company S-One			25,000
Inventories	80,000	50,000	30,000
Bonds of Company S-Two	20,000	5,000	
Dividends Receivable	8,100		
Plant and Equipment	400,000	275,000	300,000
Land	100,000	70,000	25,000
Investments:			
Stock of Company S-One	200,000		
Stock of Company S-Two	215,000		
Sinking Fund	25,000		40,000
Deficit		70,150	
	$1,234,100	$546,000	$492,000
Liabilities and Capital			
Accounts Payable	$ 50,000	$ 40,000	$ 20,000
Notes Payable	10,000	30,000	20,000
Notes Receivable Discounted	15,000	10,000	
Dividends Payable			9,000
Company H Current Account		26,000	
Company S-Two Current Account	25,000		
Advances from Company H		20,000	30,000
Advance from Company S-Two		25,000	
Accrued Interest on Bonds	3,000	5,000	3,000
Bonds Payable	200,000	100,000	100,000
Reserve for Depreciation	50,000	40,000	50,000
Capital Stock	800,000	250,000	200,000
Surplus	56,100		20,000
Sinking Fund Reserve	25,000		40,000
	$1,234,100	$546,000	$492,000

Illustration 28

COMPANIES H, S-ONE, AND S-TWO

Consolidated Working Papers

December 31, 19__

	Company H	Company S-One	Company S-Two	Adjustments		Elimination	Consolidated Balance Sheet
Debits							
Cash	28,000	31,850	15,000				74,850
Accounts Receivable	40,000	30,000	20,000				90,000
Company S-One Current Account	30,000				(*a*) 4,000	26,000 (*4*)	
Company H Current Account			25,000			25,000 (*5*)	
Notes Receivable, Company S-One	20,000					20,000 (*10*)	
Notes Receivable	18,000	14,000	12,000				44,000
Advances to Subsidiaries	50,000					50,000 (*6*)	
Advance to Company S-One			25,000			25,000 (*7*)	
Inventories	80,000	50,000	30,000				160,000
Bonds of Company S-Two	20,000	5,000				25,000 (*8*)	
Dividends Receivable	8,100					8,100 (*9*)	
Plant and Equipment	400,000	275,000	300,000				975,000
Land	100,000	70,000	25,000				195,000
Investment in Stock of Company S-One	200,000						
Eliminate Book Value Acquired: 80% of $250,000						200,000 (*1*)	
Investment in Stock of Company S-Two	215,000						
Eliminate Book Value Acquired:							
90% of $200,000 Capital Stock						180,000 (*2*)	
90% of $30,000 Surplus						27,000 (*3*)	
Goodwill							8,000*G*
Sinking Fund	25,000		40,000				65,000
Deficit—Company S-One		70,150					
Accrued Bond Interest Receivable					(*e*) 150		
Minority Share							14,000*M*
Consolidation Share							56,000*S*
	1,234,100	546,000	492,000				
Cash in Transit				(*a*) 4,000			4,000
Accrued Bond Interest Receivable	600	150		(*e*) 750		750 (*11*)	
Adjustment Totals Forward				4,750	4,150	586,850	1,685,850

Illustration 29 (*a*)

	Company H	Company S-One	Company S-Two	Adjustments		Elimination	Consolidated Balance Sheet
Credits							
Accounts Payable	50,000	40,000	20,000				110,000
Notes Payable	10,000	30,000	20,000			8,000 (*10*)	52,000
Notes Receivable Discounted	15,000	10,000				12,000 (*10*)	13,000
Dividends Payable			9,000			8,100 (*9*)	900
Company H Current Account		26,000				26,000 (*4*)	
Company S-Two Current Account	25,000					25,000 (*5*)	
Advances from Company H		20,000	30,000			50,000 (*6*)	
Advances from Company S-Two		25,000				25,000 (*7*)	
Accrued Interest on Bonds	3,000	5,000	3,000			750 (*11*)	10,250
Bonds Payable	200,000	100,000	100,000			25,000 (*8*)	375,000
Reserve for Depreciation	50,000	40,000	50,000				140,000
Capital Stock:							
Company H	800,000						800,000
Company S-One		250,000					
Eliminate 80%						200,000 (*1*)	
Minority Interest 20%							50,000*M*
Company S-Two			200,000				
Eliminate 90%						180,000 (*2*)	
Minority Interest 10%							20,000*M*
Surplus:							
Company H	56,100			(*c*) 18,000 (*b*) 7,200	(*d*) 3,600 (*e*) 600		35,100*S*
Company S-Two			20,000				
Eliminate 90% of $30,000 Acquired						27,000 (*3*)	
Minority Interest 10% of $20,000							2,000*M*
Consolidate							9,000**S*
Sinking Fund Reserve:							
Company H	25,000						25,000*R*
Company S-Two			40,000				
Minority Interest 10%							4,000*M*
Consolidate 90%							36,000*R*
	1,234,100	546,000	492,000				
Reserve for Intercompany Profit on Inventories					(*b*) 7,200		7,200*R*
Reserve for Intercompany Profit on Equipment				(*d*) 3,600	(*c*) 18,000		14,400*R*
				28,800	29,400	586,850	1,685,850
Brought Forward				4,750	4,150		
				33,550	33,550		

*Deficit.

Illustration 29 (*b*)

COMPANY H AND SUBSIDIARY COMPANIES S-ONE AND S-TWO

CONSOLIDATED BALANCE SHEET

December 31, 19__

Assets			
Current Assets:			
Cash		$ 78,850	
Accounts Receivable		90,000	
Notes Receivable	$ 44,000		
Less Notes Receivable Discounted	13,000	31,000	
Inventories	$160,000		
Less Reserve for Intercompany Profits	7,200	152,800	
Total Current Assets			$ 352,650
Fixed Assets:			
Plant and Equipment		$975,000	
Less Reserve for Intercompany Profits	$ 14,400		
Reserve for Depreciation	140,000	154,400	
Net Value		$820,600	
Land		195,000	
Total Fixed Assets			1,015,600
Sinking Funds			65,000
Goodwill			8,000
			$1,441,250
Liabilities and Capital			
Current Liabilities:			
Accounts Payable		$110,000	
Notes Payable		52,000	
Dividends Payable		900	
Accrued Interest on Bonds		10,250	
Total Current Liabilities			$ 173,150
Fixed Liabilities:			
Bonds Payable		$400,000	
Less Treasury Bonds		25,000	
Total Fixed Liabilities			375,000
Minority Interest in Subsidiaries (See Schedule)			62,000
Capital:			
Capital Stock		$800,000	
Surplus:			
Sinking Fund Reserve	$61,000		
Deficit	29,900		
Net Surplus		31,100	
Total Net Worth			831,100
			$1,441,250

ILLUSTRATION 30

SCHEDULE OF MINORITY INTERESTS

	TOTAL	COMPANY S-ONE	COMPANY S-TWO
Capital Stock	$70,000	$50,000	$20,000
Surplus	2,000		2,000
Sinking Fund Reserve	4,000		4,000
Total	$76,000	$50,000	$26,000
Deficit	14,000	14,000	
Net Value	$62,000	$36,000	$26,000

ILLUSTRATION 31

CONSOLIDATED SURPLUS RECONCILATION

Company H Surplus per Books			$56,100
Add, Bond Interest Earned			600
Total			$56,700
Deduct:			
Appropriations for Reserves for Intercompany Profits in:			
Inventories	$ 7,200		
Equipment	14,400	$21,600	
Share of Deficit of Company S-One		56,000	
Decrease in Share of Surplus, Company S-Two		9,000	
Total Deductions			86,600
Net Deficit per Consolidated Balance Sheet			$29,900

ILLUSTRATION 32

Comments.—

Consolidated Working Papers, Illustrations 29 (*a*) and (*b*):

1. Because the holding company carries its investments *at cost*, it is necessary to eliminate the book values existing at the time the interests were acquired. (Eliminations *1*, *2*, and *3*.)

2. Accounts current between Company H and Company S-One must be adjusted (Adjustment (*a*), prior to elimination (Elimination *4*).

3. Company H must set up a Reserve for Intercompany Profits in Inventories equal to 90 per cent. of the $8,000 profit made by Company S-Two (Adjustment (*b*)). Unless a consolidated statement of profit and loss is made, no attention need be paid to the intercompany profits at the beginning of the year.

4. Adjustment (*c*) recognizes the holding company's 80 per cent. of the $22,500 intercompany profit in equipment. As Company S-One gradually recovers its investment in this equipment through the medium of depreciation charges, this profit will become a realized profit. At the end of the second year, two-tenths of the $18,000 has been realized. Accordingly adjustment (*d*) reverses adjustment (*c*) for this fraction of the latter. Apparently no reserve was established when the equipment was sold or thereafter, for none appears in the balance sheet of Company H. The fact should not be overlooked that the surplus to be reduced is that of the holding company, not that of the subsidiary which owns the asset.

5. Adjustment (*e*) corrects the errors of Companies H and S-One in failing to accrue interest on bonds owned.

6. Notes Receivable Discounted are treated in accordance with suggestions made in Art. 19.

7. Only the intercompany portion of the declared dividend of Company S-Two is eliminated. The 10 per cent. payable to the minority interest is shown as a current liability (Elimination 9).

Consolidated Balance Sheet, Illustration 30:

1. It is unnecessary to make a special item of cash in transit.

2. Some accountants suggest that intercompany bondholdings should be shown as Treasury Bonds. This has been done in the balance sheet. The alternative treatment is to show only the net amount, $375,000.

3. The balance sheet may show the minority interest in each subsidiary in lieu of the schedule as shown in Illustration 31.

4. It is customary to present a statement, as Illustration 32, reconciling the surplus appearing on the consolidated balance sheet with that indicated in the balance sheet of the holding company.

22. Preferred Stock.—Thus far the discussion has concerned the ownership by the holding company of par-value common stock only. It is not unusual for a hold-

Working Papers for Case 1

	Company H	Company S	Eliminations	Consolidated Balance Sheet
Investment in Common Stock	205,000			
Eliminate:				
80% of $200,000			160,000	
80% of $60,000			48,000	
Goodwill				3,000**G*
Investment in Preferred Stock	70,000			
Eliminate				
60% of $100,000			60,000	
Goodwill				10,000*G*
			268,000	
Common Stock		200,000		
Eliminate 80%			160,000	
Minority				40,000*M*
Preferred Stock		100,000		
Eliminate 60%			60,000	
Minority				40,000*M*
Surplus:				
To Common Stock		60,000		
Eliminate 80%			48,000	
Minority				12,000*M*
			268,000	

*Negative Goodwill.

Illustration 33

Working Papers for Case 2

	Company H	Company S	Eliminations	Consolidated Balance Sheet
Investment in Common Stock	205,000			
Eliminate:				
80% of $200,000			160,000	
80% of $52,000			41,600	
Goodwill				3,400*G*
Investment in Preferred Stock	70,000			
Eliminate:				
60% of $100,000			60,000	
60% of $8,000			4,800	
Goodwill				5,200*G*
			266,400	
Common Stock		200,000		
Eliminate 80%			160,000	
Minority				40,000*M*
Preferred Stock		100,000		
Eliminate 60%			60,000	
Minority				40,000*M*
Surplus:				
To Common Stock		52,000		
Eliminate 80%			41,600	
Minority				10,400*M*
To Preferred Stock		8,000		
Eliminate 60%			4,800	
Minority				3,200*M*
			266,400	

Illustration 34

ing company to own both common and preferred stock of a subsidiary company. If both classes are held, two eliminations must be made in the working papers in place of the one that has been explained. Only one difficulty is likely to arise; *the determining of the preferred stock's interest in the surplus balance.* This demands a close investigation of the preferred-stock contract, to discover whether the stock is cumulative or non-cumulative, participating or non-participating, and of the preferred-stock dividend record to discover whether any dividends are in arrears.

The preferred-stock investment may be carried in either of the alternative manners described for common stock: that is, at cost or at current value. If the stock happens to be non-cumulative, it is probably advisable to carry it at cost, even though the holding company's total interest gives it control over the dividend policy of the subsidiary.

The working papers, Illustrations 33, 34, 35, represent these facts: Company S, at date of acquisition, has Common Stock of $200,000, 6-per-cent. Preferred Stock of $100,000, and Surplus of $60,000. Company H acquires 80 per cent. of the common stock for $205,000 and 60 per cent. of the preferred stock for $70,000. Three cases, as follow, are illustrated:

Case 1.—The preferred is non-participating and non-cumulative. Full dividends have been paid each year since the preferred was issued. Hence, the preferred has no further interest in surplus.

Case 2.—The preferred is cumulative but non-participating. During the last two years only $4,000 (that is, two 2-per-cent. declarations) has been paid in preferred dividends. Thus the preferred has a prior claim of $8,000 on the surplus.

Case 3.—The preferred is both cumulative and participating. Full dividends due to date on preferred have been paid. The participation is share for share with the common stock.

The working papers for the three Cases are shown in Illustrations 33, 34, and 35, respectively.

Working Papers for Case 3

	Company H	Company S	Eliminations	Consolidated Balance Sheet
Investment in Common Stock	205,000			
Eliminate:				
80% of $200,000			160,000	
80% of $40,000			32,000	
Goodwill				13,000*G*
Investment in Preferred Stock	70,000			
Eliminate:				
60% of $100,000			60,000	
60% of $20,000			12,000	
Goodwill				2,000**G*
			264,000	
Common Stock		200,000		
Eliminate 80%			160,000	
Minority				40,000*M*
Preferred Stock		100,000		
Eliminate 60%			60,000	
Minority				40,000*M*
Surplus:				
To Common Stock		40,000		
Eliminate 80%			32,000	
Minority				8,000*M*
To Preferred Stock		20,000		
Eliminate 60%			12,000	
Minority				8,000*M*
			264,000	

*Negative Goodwill.

Illustration 35

23. Stock Without Par Value.—No special problem arises if the stock of a subsidiary is no-par value stock. The investment account should indicate the number of shares owned and may be carried either at cost or at the current value as shown by the books of the subsidiary.

Consolidated Working Papers

	Company H	Company X	Eliminations	Consolidated Balance Sheet
Debits				
Investment in Company X. 6,400 out of 10,400 shares	243,200			
Eliminate $\frac{8}{13}$ of Net Worth			220,800	
Goodwill				22,400*G*
			220,800	
Credits				
Capital Stock No-Par Value		289,120		
Eliminate $\frac{8}{13}$			177,920	
Minority				111,200*M*
Capital Surplus		47,840		
Eliminate $\frac{8}{13}$			29,440	
Minority				18,400*M*
Surplus		21,840		
Eliminate $\frac{8}{13}$			13,440	
Minority				8,400*M*
			220,800	

Illustration 36

Working Papers, if Investment is Carried at Cost

	Company H	Company X	Eliminations	Consolidated Balance Sheet
Debits				
Investment in Company X 6,400 out of 10,400 shares	243,200			
Eliminate Book Value Acquired			220,800	
Goodwill				22,400*G*
			220,800	
Credits				
Capital Stock No Par Value		289,120		
Eliminate $\frac{8}{13}$			177,920	
Minority				111,200*M*
Capital Surplus		47,840		
Eliminate $\frac{8}{13}$			29,440	
Minority				18,400*M*
Surplus		5,720		
Eliminate $\frac{8}{13} \times \$21,840$			13,440	
Minority $\frac{5}{13} \times \$5,720$				2,200*M*
Consolidate $\frac{8}{13}$ of $16,120 decrease				9,920**S*
			220,800	

*Deficit.

Illustration 37

Assume that Company H buys 6,400 shares of the no-par value common stock of Company X at $38 per share. At the date of acquisition, Company X has 10,400 shares of this stock outstanding, a credit to Capital Stock account of $289,120, a capital surplus of $47,840, and an earned surplus of $21,840.

The consolidated working papers at date of acquisition will be as in Illustration 36.

Working Papers if Profits and Losses are Taken Up

	Company H	Company X	Eliminations	Consolidated Balance Sheet
Debits				
Investment in Company X	233,280			
6,400 out of 10,400 shares				
Eliminate				
$\frac{8}{13} \times \$289,120$			177,920	
$\frac{8}{13} \times \$\ 47,840$			29,440	
$\frac{8}{13} \times \$\ \ 5,720$			3,520	
Goodwill				22,400*G*
			210,880	
Credits				
Capital Stock No Par Value		289,120		
Eliminate $\frac{8}{13}$			177,920	
Minority				111,200*M*
Capital Surplus		47,840		
Eliminate $\frac{8}{13}$			29,440	
Minority				18,400*M*
Surplus		5,720		
Eliminate $\frac{8}{13}$			3,520	
Minority				2,200*M*
			210,880	

Illustration 38

If, during the first year of Company H's control, Company X makes a profit of $35,880 and pays dividends of $5.00 per share, the consolidated working papers one year after date of acquisition will appear as in Illustration 37, if the investment is carried at cost. If profits and losses are taken up, the working papers will be as in Illustration 38.

24. Changes in Consolidated Goodwill.—In the preceding working papers the reader will have noted the fact that the consolidated goodwill apparently remains constant in amount. Whether the investment in a subsidiary company is carried at cost or at current value the goodwill, positive or negative, will remain constant in amount *unless the holding company alters its percentage of ownership in the subsidiary.*

Change Because of Sale or Purchase of Shares.—One of the simplest ways to alter the percentage of ownership is to sell some of the shares owned or to buy

additional shares. If Company A pays $273,000 for a 90-per-cent. interest in Company B when the latter has $200,000 of capital stock and $80,000 of surplus, $21,000 is paid for goodwill. If, sometime later, when Company B has capital stock of $200,000 and surplus of $30,000, Company A sells 300 of its 1,800 shares for $75,000, how should the sale be recorded, the investment having been carried at current value? What is the effect on the consolidated goodwill? These questions may be answered as follows:

Net Worth of Company B:		
Capital Stock	$200,000	
Surplus	30,000	
Total	$230,000	
90% of same		$207,000
Add goodwill purchased		21,000
Investment account of Company A		$228,000

Journal Entry

Cash	$75,000	
Investment in Company B		$38,000
Profit on Sale of Securities		37,000
To record sale of 300 shares of stock carried at $126.67 per share.		

Goodwill originally acquired	$ 21,000
One-sixth of same	3,500
Goodwill retained	$ 17,500

Company A's Investment account:		
Balance before sale		$228,000
Less shares sold		38,000
Balance after sale		$190,000
Net Worth of Company B,	$230,000	
75 per cent. of same		172,500
Goodwill		$ 17,500

Change Because of Issuing of Stock Rights.—The issuing of stock rights by the subsidiary corporation is likely to result in a change in the amount of consolidated goodwill. The change results only indirectly from the stock rights and is the direct result of the failure of certain stockholders to exercise their privilege to subscribe for additional shares. It may be that certain minority stockholders forfeit their rights, or that the holding company forfeits rights attaching to certain shares, or that both the holding company and the minority stockholders fail (but in different degrees) to take advantage of their rights.

Company H owns 80 per cent. of the capital stock of Company S. On December 31, 19__, the subsidiary has stock of $100,000 and surplus of $80,000. The investment account on the books of the holding company, after being increased for that company's share of the year's profits, has a balance of $150,000, indicating a

payment of $6,000 for goodwill. The subsidiary corporation issues rights permitting the holder of five shares of stock to subscribe for one new share at 120. The effect on the consolidated goodwill is indicated in the three following hypothetical cases.

Case 1.—Both the holding company and the minority take full advantage of their rights.

	Company S	Company H	Minority
Capital Stock	$100,000	$ 80,000	$20,000
New Shares Subscribed	20,000	16,000	4,000
Surplus	80,000	64,000	16,000
Paid-in Surplus	4,000	3,200	800
Minority's Equity			$40,800
Holding Company's Equity		$163,200	
Company S, Net Worth	$204,000		
Company H, Investment:			
December 31, 19__, Balance	$150,000		
Add, 160 Shares at 120	19,200	169,200	
Goodwill		$ 6,000	

Case 2.—The holding company takes full advantage of its rights but the minority stockholders subscribe for only twenty-five shares, the remaining rights being allowed to lapse.

Net Worth of Company S:

Capital Stock	$118,500
Surplus	80,000
Paid-in Surplus	3,700
Total	$202,200

Company H's Investment:

Balance, 800 Shares carried at	$150,000
Subscribed, 160 Shares at 120, cost	19,200
Total (960 Shares out of 1,185)	$169,200
$\frac{960}{1185}\times$\$202,200	163,807
Goodwill	$ 5,393

Note.—Company H's interest in Company S has increased from 80 per cent. to 81.01 per cent.

Case 3.—Company H subscribes for 100 shares but the minority stockholders take full advantage of their rights.

Net Worth of Company S:

Capital Stock	$114,000
Surplus	80,000
Paid-in Surplus	2,800
Total	$196,800

Company H's Investment:

Balance, 800 Shares carried at	$150,000
Subscribed, 100 Shares at 120, cost	12,000
Total (900 Shares out of 1,140)	$162,000
$\frac{900}{1140}\times$\$196,800	155,368
Goodwill	$ 6,632

Note.—Company H's interest in Company S has decreased from 80 per cent. to 78.947 per cent.

25. Stock Dividends.—To illustrate the accounting procedures to be observed by the holding company in recording the payment of a stock dividend by a subsidiary corporation, the following facts are assumed:

On December 31, 1933, Company S had capital stock of $300,000 and surplus of $100,000.

On the same date, Company H paid $325,000 for 75 per cent. of the outstanding stock.

During 1934 Company S earned $50,000.

On December 31, 1934, Company S paid a 30-per-cent. stock dividend.

Case 1.—The working papers shown in Illustration 39 indicate the eliminations to be made if Company H's investment is carried at cost.

Consolidated Working Papers, Case 1

	Company H	Company S	Eliminations	Consolidated Balance Sheet
Investment in Stock of Company S	392,500†			
Eliminate:				
75% of Capital Stock, $300,000			225,000	
75% of Stock Dividend, $90,000			67,500	
75% of Surplus, $100,000			75,000	
Goodwill				25,000*G*
			367,500	
Capital Stock		390,000		
Eliminate 75%			292,500	
Minority 25%				97,500*M*
Surplus:				
Company H	67,500†			67,500*S*
Company S		60,000		
Eliminate 75% of $100,000 Acquired			75,000	
Minority 25%				15,000*M*
Consolidate 75% of $40,000 Decrease				30,000**S*
			367,500	

*Deficit.

†As is indicated above, the dividend was taken up by a debit to the investment account and a credit to surplus.

Illustration 39

Case 2.—If the holding company carries its investment at current value, the stock dividend causes no change in the balance of the account. There should be, however, a ledger notation of the increase in number of shares owned. Working papers for this case are shown in Illustration 40.

Consolidated Working Papers, Case 2

	Company H	Company S	Eliminations	Consolidated Balance Sheet
Investment in Stock of Company S	362,500			
Eliminate 75% of Book Value			337,500	
Goodwill				25,000*G*
			337,500	
Capital Stock		390,000		
Eliminate 75%			292,500	
Minority 25%				97,500*M*
Surplus:				
Company H	37,500			37,500*S*
Company S		60,000		
Eliminate 75%			45,000	
Minority 25%				15,000*M*
			337,500	

Illustration 40

26. Stock Bought Directly from Subsidiary.—The holding corporation may acquire some or all of its shares directly from the subsidiary corporation instead of, as assumed in all preceding cases, from the stockholders of the subsidiary. Whether acquired from one or both sources, the purchased shares are set up originally at cost in the investment account. No special problem arises. The investment account may be continued at cost or, preferably, at current value. The situation may be briefly illustrated as follows:

Company B has outstanding stock of $150,000, unissued stock of $50,000, and surplus of $40,000. Company A acquires from the old stockholders 600 shares at 130 and pays $70,000 to Company B for the unissued stock, a total investment of $148,000.

Following these transactions, the net worth of Company B is:

Capital Stock	$200,000
Surplus	40,000
Capital Surplus	20,000
Total	$260,000
Value per share	$ 130

The eliminations in consolidated working papers at date of acquisition are as in Illustration 41.

Consolidated Working Papers

	Company A	Company B	Eliminations	Consolidated Balance Sheet
Investment in Company B	148,000			
Eliminate 55% of Book Value			143,000	
Goodwill				5,000*G*
			143,000	
Capital Stock		200,000		
Eliminate 55%			110,000	
Minority 45%				90,000*M*
Surplus		40,000		
Eliminate 55%			22,000	
Minority 45%				18,000*M*
Capital Surplus		20,000		
Eliminate 55%			11,000	
Minority 45%				9,000*M*
			143,000	

Illustration 41

It should be noted that the eliminations are based on Company B's book value *after* receipt of the payment from Company A.

27. Reciprocal Stock Ownership.—It sometimes happens that the subsidiary company is found to be the owner of shares of stock in the holding company. These shares may have been received in any of several ways: (1) by purchase prior to the date at which the company became a subsidiary, (2) as payment on an account receivable, (3) as collateral on a customer's dishonored note, (4) by gift, or (5) from an exchange of stock with the parent company.

In such cases, the net worths of the respective companies must be determined simultaneously. The following statements of Companies X and Y will demonstrate the reason for this.

Company X		Company Y	
Cash, etc.	$ 85,000	Cash, etc.	$60,000
Stock of Y	65,000	Stock of X	10,000
	$150,000		$70,000
Liabilities	$ 15,000	Capital Stock	$50,000
Capital Stock	100,000	Surplus	20,000
Surplus	35,000		
	$150,000		$70,000

It may be assumed that Company Y paid par value for 10 per cent. of Company X's stock when the latter was organized several years ago and that one year ago Company X paid $65,000 for 90 per cent. of Company Y's outstanding stock of $50,000 and surplus of $10,000.

Company X wishes to take up its share of Company Y's profit for the year. *According to the books of Company Y*, there has been an increase of $10,000 in surplus. Hence, $9,000 should be taken up. But Company Y owns 10 per cent. of Company X. *According to the books of Company X*, this equity is worth $13,500. Hence, Company Y may well regard its investment as understated by $3,500. If this is true, the surplus of Company Y is likewise understated by $3,500. It now follows that the share of Company X is 90 per cent. not of $70,000, but of $73,500. Consequently, the investment of Company X in Company Y increases by $3,150 (90% of $3,500) and this, in turn, again increases the value of Company Y's investment in Company X.

From the foregoing it will be evident that a hopeless situation, a senseless reasoning in a circle, results unless the two values are determined simultaneously. It is impossible to determine first the true value of one company and then the true value of the other company.

The following procedure is regarded as the simplest available.

	Company X	Company Y
Total Assets	$150,000	$70,000
Less Liabilities	15,000	
Net Worth per Books	$135,000	$70,000
Less Investments	65,000	10,000
Net Worth other than Investments	$ 70,000	$60,000

Let x = actual worth of Company X
y = actual worth of Company Y

Then,

(1)	$x = \$70{,}000 + .9y$	
(2)	$y = \$60{,}000 + .1x$	
(3)	$.1x = .09y \quad + \$\ 7{,}000$	$\frac{1}{10}$ of (1)
(4)	$.1x = y \quad - \ 60{,}000$	from (2)
(5)	$0 = -.91y \ + \$67{,}000$	(3) − (4)
(6)	$.91y = \$67{,}000$	from (5)
(7)	$y = \$73{,}626.37$	from (6)
(8)	$x = \$70{,}000 + .9(\$73{,}626.37)$	from (1) and (7)
(9)	$x = \$136{,}263.73$	

The actual net worth in the cases of Companies X and Y may now be restated as follows:

Restatement of Net Worth

	Company X	Company Y
Actual Net Worth	$136,263.73	$73,626.37
Capital Stock	100,000.00	50,000.00
Surplus	$ 36,263.73	$23,626.37

Minority Interest Company Y

Capital Stock	$5,000
Surplus	2,363
Total	$7,363

The working papers would then be prepared as shown in Illustration 42.

Consolidated Working Papers

	Company X	Company Y	Eliminations	Consolidated Balance Sheet
Cash, etc.	85,000	60,000		145,000
Investment in Company Y	65,000			
Eliminate:				
90% of $50,000			45,000	
90% of $10,000			9,000	
Goodwill				11,000*G*
Investment in Company X		10,000		
Eliminate			10,000	
	150,000	70,000	64,000	156,000
Liabilities	15,000			15,000
Capital Stock:				
Company X	100,000			
Eliminate 10%			10,000	
Consolidate				90,000
Company Y		50,000		
Eliminate 90%			45,000	
Minority 10%				5,000*M*
Surplus:				
Company X	35,000			35,000*S*
Company Y		20,000		
Eliminate 90% of $10,000			9,000	
Minority 10% of $23,626.37				2,363*M*
Consolidate				8,637*S*
	150,000	70,000	64,000	156,000

Illustration 42

It was indicated at the beginning of this Article that Company X wished to carry its investment at current value. There may be some justification, in view of the close association of the two companies, for Company Y to do likewise. The following journal entries accomplish this purpose and, of course, result in the elimination from the investment accounts of any payments made for goodwill.

Company X:		
Investment in Company Y	$1,263	
Surplus		$1,263
Company Y:		
Investment in Company X	$3,626	
Surplus		$3,626

Working paper eliminations are then made as shown in Illustration 43.

It may be objected that Company Y, owning only 10 per cent. of Company X, should continue its investment at cost price. If this practice is followed, the working papers appear as in Illustration 44.

Consolidated Working Papers

	Company X	Company Y	Eliminations	Consolidated Balance Sheet
Cash, etc.	85,000	60,000		145,000
Investment in Company Y	66,263			
Eliminate 90% of $73,626			66,263	
Investment in Company X		13,626		
Eliminate 10% of $136,264			13,626	
	151,263	73,626	79,889	145,000
Liabilities	15,000			15,000
Capital Stock:				
Company X	100,000			
Eliminate 10%			10,000	
Consolidate				90,000
Company Y		50,000		
Eliminate 90%			45,000	
Minority 10%				5,000*M*
Surplus:				
Company X	36,263			
Eliminate 10%			3,626	
Consolidate				32,637*S*
Company Y		23,626		
Eliminate 90%			21,263	
Minority				2,363*M*
	151,263	73,626	79,889	145,000

Illustration 43

Consolidated Working Papers

	Company X	Company Y	Eliminations	Consolidated Balance Sheet
Cash, etc.	85,000	60,000		145,000
Investment in Company Y	66,263			
Eliminate 90% of Capital Stock			45,000	
Surplus			18,000	
Negative Surplus				3,263*S*
Investment in Company X		10,000		
Eliminate 10% of Capital Stock			10,000	
	151,263	70,000	73,000	148,263
Liabilities	15,000			15,000
Capital Stock:				
Company X	100,000			
Eliminate 10%			10,000	
Consolidate 90%				90,000
Company Y		50,000		
Eliminate 90%			45,000	
Minority 10%				5,000*M*
Surplus:				
Company X	36,263			36,263*S*
Company Y		20,000		
Eliminate 90%			18,000	
Minority 10% of $23,626				2,363*M*
Consolidate				363**S*
	151,263	70,000	73,000	148,263

*Deficit.

Illustration 44

Consolidated balance sheets prepared from the foregoing three sets of working papers, Illustrations 42, 43, and 44, are identical except that the first exhibits an $11,000 consolidated goodwill with a corresponding increase in surplus.

It may be assumed that during the next year the two companies' books reveal:

	Company X	Company Y
Profits from operations	$ 20,000	$ 8,000
Dividends from X 10%		1,000
Dividends from Y 30%	13,500	
	$ 33,500	$ 9,000

and that the balance sheets are as follows:

	Company X	Company Y
Cash, etc.	$113,500	$64,000
Investment in Company Y	52,763	
Investment in Company X		10,000
	$166,263	$74,000
Liabilities	$ 20,000	$10,000
Capital Stock	100,000	50,000
Surplus	46,263	14,000
	$166,263	$74,000

Computations

	Company X	Company Y
Net Worth per Books	$146,263	$64,000
Less Investments	52,763	10,000
Net Assets other than Investments	$ 93,500	$54,000

The actual net worth is calculated as follows:

Let x = actual worth of Company X
y = actual worth of Company Y

Then:

(1) $x = .9y + \$93{,}500$
(2) $y = .1x + \$54{,}000$

(3) $x = .9y + \$93{,}500$
(4) $.09x = .9y - \$48{,}600$ .9 of (2)

(5) $.91x = \$142{,}100$ (3) − (4)

(6) $x = \$156{,}154$
(7) $y = \$54{,}000 + .1(\$156{,}154)$
(8) $y = \$69{,}615$

	Company X	Company Y
Actual Net Worth	$156,154	$69,615
Capital Stock	100,000	50,000
Surplus	$ 56,154	$19,615

JOURNAL ENTRY ON COMPANY X BOOKS

Investment in Company Y.	$ 9,891	
Surplus.		$ 9,891
To set up increase in net worth arising from increase in value of investment in stock of Company Y.		

Computed Surplus	$56,154
Surplus per Books	46,263
Increase.	$ 9,891

The Consolidated Working Papers are as shown in Illustration 45, and the Consolidated Balance Sheet in Illustration 46.

CONSOLIDATED WORKING PAPERS

	Company X	Company Y	Eliminations	Consolidated Balance Sheet
Cash, etc.	113,500	64,000		177,500
Investment in Company Y	62,654			
Eliminate 90% of Capital Stock			45,000	
Surplus			12,600	
Negative Surplus				5,054S
Investment in Company X		10,000		
Eliminate 10% of Capital Stock			10,000	
	176,154	74,000	67,600	182,554
Liabilities	20,000	10,000		30,000
Capital Stock:				
Company X	100,000			
Eliminate 10%			10,000	
Consolidate 90%				90,000
Company Y		50,000		
Eliminate 90%			45,000	
Minority 10%				5,000M
Surplus:				
Company X	56,154			56,154S
Company Y		14,000		
Eliminate 90%			12,600	
Minority 10% of $19,615				1,962M
Consolidate				562*S
	176,154	74,000	67,600	182,554

*Deficit. Computations to nearest dollar.

ILLUSTRATION 45

COMPANY X AND SUBSIDIARY COMPANY Y

CONSOLIDATED BALANCE SHEET

(Two years after acquisition)

Assets:		*Liabilities and Capital:*	
Cash, etc.	$177,500	Liabilities	$ 30,000
		Minority Interest	6,962
		Capital Stock	90,000
		Surplus	50,538
	$177,500		$177,500

ILLUSTRATION 46

QUESTIONS AND PROBLEMS

Answers and solutions to the following questions and problems are now to be prepared by you after careful study of the foregoing chapter. Any good quality of paper on which your work will appear neat and legible may be used.

(1) The balance sheet of Company M, a holding company, contains as an asset, Company O Current Account, $62,000. As of the same date, Company O revealed a liability, Company M Current Account, $60,000. What might be the cause of the discrepancy? How should such facts be handled in preparing a consolidated balance sheet?

(2) Company H owns 90 per cent. of Company S and 70 per cent. of Company T. These interests were acquired in 1928.

On July 1, 1933, Company S sold certain equipment to Company H at a profit of $15,000. Company H has continued the asset on its books at the price paid to Company S, namely $120,000. Depreciation is at the rate of 10 per cent. annually.

How should these facts appear in consolidated working papers at June 30, 1934?

(3) Assume the essential facts stated in Question 2 and answer the question on the assumption that the equipment was sold by Company H to Company S.

(4) Again refer to Question 2. Indicate the consolidated working-paper treatment of the facts if the equipment had been sold by Company T to Company S.

(5) Company A purchased 90 per cent. of the stock of Company B at January 1, 1934, paying $140,000 therefor. At that date, Company B had capital stock of $100,000 and surplus of $50,000. During the year, Company B made a profit of $25,000 and at the end of the year declared and issued a stock dividend of $40,000. Company A's investment is carried at cost. Set out the above facts in consolidated working-paper form.

(6) Company A owns 80 per cent. of the capital stock of Company B. When this interest was acquired, the balance sheet of Company B showed capital stock of $400,000 and surplus of $160,000. The purchase price of the stock was $470,000. On December 31, 1934, the holding company sold 1,600 shares of Company B stock for $150,000 cash. At this date the subsidiary had capital stock of $400,000 and surplus of $60,000. The investment was carried on the books of Company A at current value.

Give the journal entry to record the sale. What is the effect on the consolidated goodwill?

(7) Company M owns 80 per cent. of the capital stock of Company N. On July 1, 19__ Company N recorded the sale of its 6-per-cent. 10-year bonds as follows:

Cash	$91,000	
Bond Discount and Expense	9,000	
Bonds Payable		$100,000

On the same date, Company M recorded the purchase of $15,000 par value of this issue:

Bonds Owned	$13,650	
Cash		$ 13,650

Interest is payable July and January first.

Set forth the above facts as they should appear in consolidated working papers for December 31 of following year.

(8) Following are the balance sheets of Companies H and S at December 31, 1934:

COMPANY H

Current Assets	$ 30,000	Current Liabilities	$ 14,000
Fixed Assets	50,000	Capital Stock	80,000
Investment in Co. S	30,000	Surplus	16,000
	$110,000		$110,000

COMPANY S

Current Assets	$20,000	Current Liabilities	$12,000
Fixed Assets	22,000	Mortgage Payable	20,000
Investment in Co. H	8,000	Capital Stock	20,000
Deficit	2,000		
	$52,000		$52,000

The investment of Company S in Company H represents a 10-per-cent. interest acquired some 10 years ago when Company H was organized.

The investment of Company H in Company S represents an 80-per-cent. interest acquired when the book value of Company S' stock was 150.

From the foregoing information prepare consolidated working papers and a consolidated balance sheet at December 31, 1934. Show all computations.

Look over your answers and solutions to the above questions and problems and immediately send them to the Schools for correction.

CHAPTER V

CONSOLIDATED PROFIT AND LOSS STATEMENTS

28. Purpose.—The holding company wishes to know the gains or losses of the consolidation. The consolidated profit and loss statement is designed to set forth this information. It may be prepared from either the trial balances or the profit and loss statements of the related companies together with certain other data. The statement reveals not only the profit or loss for the period but also the distribution of this amount between the consolidation and the various minority interests.

29. Combinations and Eliminations.—In preparing the consolidation's profit and loss statement, recourse is had to working papers not unlike those already presented. Like items among the nominal accounts are combined. Intercompany items, such as sales and purchases, interest earned and interest expense, etc., are eliminated. The final result should be restricted to those items which reflect transactions between the consolidation and parties outside the consolidation.

Intercompany profits in inventories must be recognized and adequate reserves established to avoid the anticipating of unrealized profits. The computation of the amount of the reserve for profits in the inventories at the close of the fiscal period has already been presented. The offsetting debit was made to the surplus account of the holding company. This procedure was justified by the fact that the surplus account was overstated through having been credited with overstated profits for the period just closed. If, however, the consolidated profit is correctly stated, the surplus of the holding company will not be inflated, and consequently it would be improper to reduce the surplus in setting up the reserve. To reduce the profit to the amount actually earned, the closing inventories should be reduced to cost price to the consolidation. This results in an increase to the cost of goods sold. The working-paper adjustment *debits cost of goods sold* and *credits the reserve.*

The inventories at the beginning of the year are treated in the opposite manner. It will be realized that the opening inventories "per books of the respective companies" are overstated in so far as cost to the consolidation is concerned if they contain intercompany profits. These inventories are used as debits in determining the cost of goods sold for the period under review. To avoid overstating the consolidated cost of goods sold, an adjustment is made *crediting cost of goods sold* and *debiting the surplus of the holding company.* It should be realized that the Reserve for Intercompany Profits in Inventories appears in the working papers and on the consolidated balance sheet. *This reserve is not a ledger account.* It is a working-paper segregation of a part of the holding company's surplus. Set up at the close of the period, it is a valuation account for the inventories. The same *amount* must be taken (a year later) from the same *inventories* but these inventories

will then be regarded as the *opening inventories* of the period then closing. At this time, as stated, an adjustment will be made crediting cost of goods sold and debiting the surplus of the holding company.

Occasionally it is necessary to make adjustments for items in transit. For example, the records of Company A may show purchases of $100,000 from Company B. The books of B, on the other hand, may reveal sales to A of $115,000, the discrepancy arising from the fact that B has shipped goods not yet received by A. The consolidated working papers must, then, contain an adjustment of A's books, debiting Purchases and crediting the account with Company B. A second situation requiring similar treatment may arise if one member of the consolidation owns securities issued by another member. Assume that Company X owns $10,000 worth of the preferred stock of Company Y, and that, on December 5, the directors of Company Y declare a dividend of 4 per cent. on this issue, payable December 28 to stockholders of record December 20. On the last-named date, Company X recognizes the dividend by debiting Dividends Receivable and crediting Income from Investments, and the former account appears in the December 31 trial balance at $400. Since Company Y has paid its declared dividend on December 28, no Dividends Payable account exists against which the Dividends Receivable on Company's X's books may be eliminated. The books of Company X must be adjusted by a debit to Cash in Transit and a credit to Dividends Receivable.

If, however, Company X does not recognize the dividend declaration prior to taking off the December 31 trial balance, there results an understatement of both current assets and income for the year. In such case, adjustment is made by debiting Cash in Transit and crediting Income from Investments.

COMPANIES A, B, AND C

TRIAL BALANCES

	Company A	Company B	Company C
Debits			
Cash	$ 9,905	$ 22,571	$ 6,360
Customers	10,000	10,200	10,500
Notes Receivable	6,000	3,500	3,000
Advances to Subsidiaries	7,000	. . . .	. . . .
Inventories	4,800	6,000	3,600
Plant and Equipment	40,000	28,000	35,000
Land	2,500	3,800	1,000
Investment in Company B	31,400	. . . .	. . . .
Investment in Company C	14,500	. . . .	. . . .
Bonds Owned	5,000	8,500	. . . .
Bond Sinking Fund	15,000	. . . .	. . . .
Bond Discount	1,500	. . . .	. . . .
Organization Expense	. . . .	3,500	1,500
Prepaid Insurance	480	520	380
Purchases	45,000	54,000	43,800
Selling Expense	17,500	10,500	9,500
Administrative Expense	13,080	12,120	8,300
Bond Interest	825	450	250
Dividends Paid	5,000	4,500	1,600
	$229,490	$168,161	$124,790
Credits			
Accounts Payable	$ 9,300	$ 7,000	$ 6,790
Notes Payable	3,000	. . . .	. . . .
Notes Receivable Discounted	1,000	. . . .	2,500
Advances from Company A	. . . .	4,000	2,000
Bonds Payable	30,000	10,000	5,000
Reserve for Depreciation	5,500	8,500	16,500
Capital Stock	50,000	30,000	20,000
Reserve for Sinking Fund	15,000	. . . .	. . . .
Reserve for Contingencies	3,000	1,000	. . . .
Surplus	17,825	12,605	2,250
Sales	89,620	94,631	69,750
Bond Interest Income	235	425	. . . .
Sinking Fund Income	450	. . . .	. . . .
Dividends Received	4,560	. . . .	. . . .
	$229,490	$168,161	$124,790

ILLUSTRATION 47

30. Illustrative Problem No. 1.—The trial balances of Companies A, B, and C at December 31, 1932, are shown in Illustration 47. Following are additional data:

Additional Data:

1. Investments in other companies are carried at cost. The investment in Company B represents an 80-per-cent. interest purchased December 31, 1928, when Company B had capital stock of $30,000 and surplus of $8,000. The investment in Company C was acquired January 1, 1932, when that company had capital stock of $20,000 and surplus of $4,600. It is a 60-per-cent. interest.

2. Dividends were declared October 1, payable October 31, to stockholders of record October 15 as follows: Company A, 10 per cent., Company B, 15 per cent., Company C, 8 per cent.

3. Bonds Payable are:

	TIME	RATE	INTEREST DATE
Company A	20 years	5%	Jan.–July
Company B	10 years	6%	Apr.–Oct.
Company C	20 years	6%	May–Nov.

4. Company A owns $3,000 worth of Company B's bonds and $2,000 worth of Company C's bonds. Company B owns $8,500 worth of the bonds of Company C.

5. Company A's bonds were sold at 90. The discount is being accumulated on a straight-line basis. The bonds of companies B and C were sold at par.

6. Company A's annual contribution to its sinking fund is $1,500. Deposits are made in cash on January 1.

7. Intercompany sales were:

Company B to Company A	$30,000
Company C to Company A	$10,000
Company C to Company B	$20,000

8. Inventories December 31, 1932:

Company A	$5,000
Company B	$5,500
Company C	$4,000

9. On January 1, 1932, the inventory of Company A contained goods on which Company B had made a profit of $500 and goods on which Company C had made a profit of $200.

10. Intercompany profits in inventories December 31, 1932, were:

Company A	$250 profit to Company B
	$300 profit to Company C
Company B	$350 profit to Company C

11. Accounts receivable of Company C contain $3,000 due from Company A and $2,500 due from Company B.

12. The notes receivable discounted account on the books of Company C represents one note of $2,500 issued by Company A in payment for goods purchased. There are no other intercompany notes.

13. Insurance unexpired December 31, 1932:

Company A	$340
Company B	$410
Company C	$220

14. Depreciation on plant and equipment is 8 per cent. per annum.

15. On January 1, 1931, Company B sold certain equipment to Company A for $2,000 and on this sale realized a profit of $400. The asset is still carried in the plant account at $2,000.

16. On December 30, 1932, Company B forwarded to Company A a check for $1,000 in partial repayment of advances received from the parent company.

17. It has been customary for Company B to write off each year $500 from its Organization Expense account balance.

18. Disregard all income taxes.

COMPANY A AND SUBSIDIARY COMPANIES B AND C
Consolidated Working Papers
Year Ended December 31, 1932

	Trial Balances Company A	Trial Balances Company B	Trial Balances Company C	Adjustments Dr.	Adjustments Cr.	Eliminations	Cost of Goods Sold	Cost of Goods Sold	Profit and Loss	Profit and Loss	Consolidated Balance Sheet
Debits											
Cash	9,905	22,571	6,360								38,836
Customers	10,000	10,200	10,500			5,500 *j*					25,200
Notes Receivable	6,000	3,500	3,000			2,500 *k*					10,000
Advances to Subsidiaries	7,000				1,000 *K*	6,000 *m*					
Inventories	4,800	6,000	3,600				14,400				
Plant and Equipment	40,000	28,000	35,000								103,000
Land	2,500	3,800	1,000								7,300
Investment in Company B	31,400										
Eliminate 80%											
Capital Stock						24,000 *a*					
Surplus Acquired $8,000						6,400 *b*					
Goodwill											1,000 *G*
Investment in Company C	14,500										
Eliminate 60%											
Capital Stock						12,000 *c*					
Surplus Acquired $4,600						2,760 *d*					
Goodwill (negative)											260 **G*
Bonds Owned	5,000	8,500				13,500 *n*					
Bond Sinking Fund	15,000										15,000
Bond Discount	1,500				75 *A*						1,425
Organization Expense		3,500	1,500		500 *M*						4,500
Prepaid Insurance	480	520	380		410 *F*						970
Purchases	45,000	54,000	43,800			60,000 *h*	82,800				
Selling Expense	17,500	10,500	9,500						37,500		
Administrative Expense	13,080	12,120	8,300						33,500		
Bond Interest	825	450	250	1,025 *A*		810 *f*			1,740		
Dividends Paid	5,000	4,500	1,600			4,560 *e*					{ 5,000 *S* / 900 *M* / 640 *M*
	229,490	168,161	124,790								
Accrued Interest Receivable	65	85		150 *B*		150 *g*					
Inventories December 31, 1932	5,000	5,500	4,000	14,500 *C*							14,500
Insurance Expense	140	110	160	410 *F*					410		
Depreciation Expense	3,200	2,240	2,800	8,240 *G*	*J* 25 60				8,214 40		
Cash in Transit				1,000 *K*							1,000
Total Debit Eliminations						138,180					
Balance Sheet Total											229,011
Credits											
Accounts Payable	9,300	7,000	6,790			5,500 *j*					17,590
Notes Payable	3,000										3,000
Notes Receivable Discounted	1,000		2,500			2,500 *k*					1,000
Advances from Company A		4,000	2,000			6,000 *m*					
Bonds Payable	30,000	10,000	5,000			13,500 *n*					31,500
Reserve for Depreciation	5,500	8,500	16,500	*J* 25 60	8,240 *G*						38,714 40
Capital Stock:											
Company A	50,000										50,000
Company B		30,000									
Eliminate 80%						24,000 *a*					
Minority Interest 20%											6,000 *M*
Company C			20,000								
Eliminate 60%						12,000 *c*					
Minority Interest 40%											8,000 *M*
Reserve for Sinking Fund	15,000										15,000 *S*
Reserve for Contingencies	3,000	1,000									{ 3,800 *S* / 200 *M*
Surplus:											
Company A	17,825			{ 320 *H* / 400 *D* / 500 *M*							17,105 *S*
Company B		12,605									
Eliminate 80% $8,000						6,400 *b*					
Minority 20% $12,105											2,421 *M*
Consolidate 80% $4,105 Gain											3,284 *S*
Company C			2,250								
Eliminate 60% $4,600						2,760 *d*					
Minority 40%											900 *M*
Consolidate 60% $2,350 Decrease											1,410 **S*
Sales	89,620	94,631	69,750			60,000 *h*				194,001	
Bond Interest Income	235	425			150 *B*	810 *f*					
Sinking Fund Income	450									450	
Dividends Received	4,560					4,560 *e*					
	229,490	168,161	124,790								
Accrued Interest Payable	750	150	50		950 *A*	150 *g*					800
Inventories, December 31, 1932	5,000	5,500	4,000		14,500 *C*			14,500			
Intercompany Profit in Inventories, January 1, 1932					400 *D*			400			
Reserve for Intercompany Profit in Inventories, December 31, 1932				590 *E*	590 *E*		590				590 *R*
Reserve for Intercompany Profit in Equipment					320 *H*						320 *R*
				27,160 60	27,160 60						
Total Credit Eliminations						138,180					
Cost of Goods Sold to P and L								82,890	82,890		
							97,790	97,790			
Net Profit for the Year									30,196 60		5,130 20 *M* / 25,066 40 *S*
									194,451 00	194,451	229,011 00

*Negative Goodwill

Illustration 48

COMPANY A AND SUBSIDIARY COMPANIES B AND C

Consolidated Balance Sheet

Balance 31, 1932

Assets						
Current Assets:						
Cash			$ 39,836	00		
Customers			25,200	00		
Notes Receivable	$ 10,000	00				
Less Discounted Notes	1,000	00	9,000	00		
Inventories	$ 14,500	00				
Intercompany Profit Provision	590	00	13,910	00		
Total Current Assets					$ 87,946	00
Fixed Assets:						
Plant and Equipment	$103,000	00				
Intercompany Profit Provision	320	00				
	$102,680	00				
Reserve for Depreciation	38,714	40	$ 63,965	60		
Land			7,300	00		
Total Fixed Assets					71,265	60
Bond Sinking Fund					15,000	00
Prepaid and Deferred Items:						
Unexpired Insurance			$ 970	00		
Bond Discount			1,425	00		
Organization Expense			4,500	00		
Total					6,895	00
Goodwill					740	00
Total Assets					$181,846	60
Liabilities and Capital						
Current Liabilities:						
Accounts Payable			$17,590	00		
Accrued Interest on Bonds			800	00		
Notes Payable			3,000	00		
Total Current Liabilities					$ 21,390	00
Fixed Liabilities:						
Bonds Payable					31,500	00
Minority Interest (See schedule, Illustration 50)					21,111	20
Capital:						
Capital Stock			$ 50,000	00		
Surplus (including the holding company's share of appropriated surplus of the subsidiary companies)			57,845	40		
Net Worth					107,845	40
					$181,846	60

Illustration 49

SCHEDULE OF MINORITY INTERESTS

	TOTAL	COMPANY B	COMPANY C
Capital Stock	$14,000.00	$ 6,000.00	$ 8,000.00
Reserve for Contingencies	200.00	200.00	
Surplus	1,781.00	1,521.00	260.00
Current Profits	5,130.20	3,014.20	2,116.00
	$21,111.20	$10,735.20	$10,376.00

ILLUSTRATION 50

NOTE.—The *total* minority interest may be determined from the working papers (items marked *M*) as follows:

Credits:	
Capital Stock	$14,000.00
Surplus	3,321.00
Profits	5,130.20
Reserve for Contingencies	200.00
Total	$22,651.20
Debits:	
Dividends Paid	1,540.00
Minority Interest	$21,111.20

From the foregoing material the following working papers, schedule, and statements are prepared:

1. Consolidated Working Papers from Trial Balances (Illustration 48.)
2. Consolidated Balance Sheet (Illustration 49).
3. Schedule of Minority Interests (Illustration 50).
4. Consolidated Profit and Loss Statement (Illustration 51).
5. Consolidated Surplus Statement (Illustration 52).
6. Consolidated Profit and Loss Working Papers (Illustration 53).
7. Consolidated Cost of Goods Sold Working Papers (Illustration 54).
8. Consolidated Surplus Working Papers (Illustration 55).
9. Consolidated Balance Sheet Working Papers (Illustration 56).

NOTE.—Items 6–9, inclusive, are alternatives to item 1.

Explanation of Adjusting Entries:

A To set up accrued interest on bonds and to amortize bond discount.

B To set up accrued interest receivable.

C To set up inventories at December 31.

D To reduce consolidated surplus as of January 1 and to reduce cost of goods sold in 1932 by the amount of intercompany profit in inventories at January 1, 1932 (80% of $500 = $400). No adjustment is made for the $200 profit to Company C, since the transactions resulting in this gain were completed prior to the date on which Company A made its investment in Company C.

E To increase cost of goods sold in 1932 and to establish a reserve for the amount of intercompany profits in inventories at December 31, 1932:

80% of $250 = $200
60% of $650 = 390

Total $590

F To set up insurance expense for 1932.

G To set up depreciation expense for 1932.

H To set up reserve for intercompany profit in equipment:

Profit to Company B	$400
Company A's share, 80%	320

J To remove from consolidated expense that portion of depreciation expense resulting from the overstatement of the value of the asset acquired by Company A from Company B:

Sale price	$2,000	
8%		$160.00
Cost to Make	$1,600	
Minority Profit 20% of $400	80	
Cost to Consolidation	$1,680	
8%		134.40
Adjustment		$ 25.60

K To set up cash in transit and to reduce advances to subsidiaries.

M To amortize $500 of Company B's organization expense.

Explanation of Intercompany Eliminations:

a–d Inclusive. Investments and net worth.
e Dividends received and paid.
f Interest income and expense.
g Accrued interest receivable and payable.
h Sales and purchases.
j Receivables and payables.
k Notes receivable and notes receivable discounted.
m Advances.
n Bonds owned and bonds payable.

When consolidated working papers are prepared from trial balances, it is necessary to determine the net profit (or loss) *of each subsidiary* before the minority interest in the profits can be exhibited in the Consolidated Balance Sheet column of the working papers. See the consolidated profit and loss working papers, Illustration 53.

The *detail* shown in Illustration 50 can be obtained, likewise, from the trial balance working papers except for the distribution of the minority share of the profit between Companies B and C. As has already been indicated, this is usually determined from profit and loss working papers. The results could, of course, be shown on the trial balance working papers by the addition of another line. This would introduce unnecessary confusion if there were several minority groups.

COMPANY A AND SUBSIDIARY COMPANIES B AND C

CONSOLIDATED STATEMENT OF PROFIT AND LOSS

Year Ended December 31, 1932

Sales			$194,001	00
Less Cost of Goods Sold:				
Inventories January 1, 1932	$ 14,000	00		
Purchases	82,800	00		
Goods Available for Sale	$ 96,800	00		
Less Inventories December 31, 1932	13,910	00		
Cost of Goods Sold			82,890	00
Gross Margin on Sales			$111,111	00
Less Expenses:				
Selling Expense	$ 37,500	00		
Administrative Expense	33,500	00		
Depreciation	8,214	40		
Insurance	410	00		
Total			79,624	40
Net Operating Profit			$ 31,486	60
Add Other Income:				
Sinking Fund Interest			450	00
			$ 31,936	60
Deduct Other Expense:				
Interest on Bonds Payable			1,740	00
Net Consolidated Profit for the Year			$ 30,196	60
Minority Interest, Company B	$ 3,014	20		
Minority Interest, Company C	2,116	00		
Holding Company, Company A	25,066	40		
Total	$ 30,196	60		

ILLUSTRATION 51

Alternative Working Papers.—As has been indicated, the consolidated statements may be prepared from the financial statements of the related companies plus certain additional data. In Illustrations 53, 54, 55 and 56, are given consolidated working papers in a form frequently used if they are based on the financial statements. The adjustments and eliminations have been keyed to agree exactly with the corresponding items in the working papers shown in Illustration 48 *in all except the consolidated balance sheet working papers.*

COMPANY A AND SUBSIDIARY COMPANIES B AND C

CONSOLIDATED SURPLUS STATEMENT

Year Ended December 31, 1932

Balance January 1, 1932			$ 21,109	00
Add Appropriations for:				
Bond Sinking Fund	$ 15,000	00		
Contingencies	3,800	00	18,800	00
Adjusted Balance			$ 39,909	00
Add Net Profit for the Year			25,066	40
			$ 64,975	40
Deduct:				
Dividends Paid	$ 5,000	00		
Organization Expenses (Note 1)	400	00		
Loss of Capital Assets (Note 2)	1,410	00		
Provision for Intercompany Profit in Equipment	320	00	7,130	00
Balance December 31, 1932			$ 57,845	40

NOTE 1.—Company B wrote off $500 from its organization expense. The share of the consolidation is 80 per cent. or $400.

NOTE 2.—The problem is silent in regard to the exact reason for this charge. It advises that Company C, at date of the acquisition of Company A's interest (January 1, 1932), had surplus of $4,600 and, further, that dividends of $1,600 were paid, thus reducing the surplus to $3,000. Company C's trial balance of December 31, however, shows a surplus of only $650 (after deduction of dividends paid). The difference of $2,350 has been set down as a loss of capital assets. It could as easily be a loss resulting from a damage suit, a correction of the profits of previous periods, the amortizing of goodwill, or from some other reason for a surplus charge. The consolidation's share of the loss is 60 per cent. of $2,350, or $1,410.

ILLUSTRATION 52

31. Illustrative Problem, No. 2.—Not infrequently the organization of a holding corporation is more complicated than that indicated in Illustrative Problem No. 1. A complicating factor arises when one subsidiary company has an investment in the stock of a second subsidiary company. Usually the investment of the first subsidiary is a relatively small percentage of the stock.

Actually, few changes in procedure need be employed because one subsidiary owns part of the capital stock of another. The following illustration is based on the trial balances of Companies A, B, and C as of December 31, 1932, Illustration 57, together with additional data. Particular notice should be taken of the differences between the solution to this problem and the solution to the problem given in Art. 30.

Additional Data:

1. Investments in other companies are carried at cost. Company A's investment in Company B represents an 80-per-cent. interest purchased May 25, 1928, when that company had capital stock of $300,000 and surplus of $80,000. Company A's investment in Company C was acquired January 1, 1932, when Company C had capital stock of $200,000 and surplus of $46,000. It is a 60-per-cent. interest. On June 30, 1931, Company B bought 600 of Company C's 2,000 outstanding shares. Company C had a surplus of $30,000 on that date.

COMPANY A AND SUBSIDIARY COMPANIES B AND C

Consolidated Profit and Loss Working Papers

Year Ended December 31, 1932

	Company A	Company B	Company C	Adjustments Dr.	Adjustments Cr.	Eliminations	Total
Sales	89,620	94,631	69,750	. . .	. . .	60,000 h	194,001
Less Cost of Goods Sold*	44,800	54,500	43.400	. . .	. . .	. . .	82,890
Gross Profit on Sales	44,820	40,131	26,350	. . .	. . .	. . .	111,111
Less Expenses:							
Selling Expense	17,500	10,500	9,500	. . .	. . .	. . .	37,500
Administrative Expense	13,080	12,120	8,300	. . .	. . .	. . .	33,500
Insurance	140	110	160	. . .	. . .	. . .	410
Depreciation	3,200	2,240	2,800	. . .	J 25 60	. . .	8,214 40
	33,920	24,970	20,760				79,624 40
Operating Profit	10,900	15,161	5,590	. . .	. . .	. . .	31,486 60
Add Other Income:							
Bond Interest	300	510	. . .	. . .	. . .	810 f	
Sinking Fund Income	450	. . .	. . .	. . .	. . .	. . .	450
Dividends Received	4,560	. . .	. . .	. . .	. . .	4,560 e	
Totals	16,210	15,671	5,590	. . .	. . .	. . .	31,936 60
Less Bond Interest Expense	1,650	600	300	. . .	. . .	810 f	1,740 00
Net Profit for the Year	14,560	15,071	5,290	. . .	. . .	. . .	30,196 60
Minority Interests	. . .	3,014 20	2,116	. . .	. . .	. . .	5,130 20
Holding Company's Share	. . .	. . .	. . .	. . .	. . .	. . .	25,066 40

*Note Consolidated Cost of Goods Sold Working Papers, Illustration 54.

Illustration 53

COMPANY A AND SUBSIDIARY COMPANIES B AND C

Consolidated Cost of Goods Sold Working Papers

Year Ended December 31, 1932

	Company A	Company B	Company C	Adjustments Dr.	Adjustments Cr.	Eliminations	Total
Inventories, January 1	4,800	6,000	3,600	. . .	. . .	. . .	. . .
Reserve for Intercompany Profit, January 1	. . .	. . .	. . .	. . .	400 D	. . .	
Adjusted Balance							14,000
Purchases	45,000	54,000	43,800	. . .	. . .	60,000 h	82,800
	49,800	60,000	47,400				96,800
Inventories, December 31	5,000	5,500	4,000	14,500 C	. . .	. . .	
Reserve for Intercompany Profit, December 31	. . .	. . .	. . .	590 E	. . .	. . .	13,910
Cost of Goods Sold	44,800	54,500	43,400	. . .	. . .	. . .	82,890

Illustration 54

COMPANY A AND SUBSIDIARY COMPANIES B AND C
CONSOLIDATED SURPLUS WORKING PAPERS
Year Ended December 31, 1932

	Company A	Company B	Company C	Adjustments Dr.	Adjustments Cr.	Eliminations	Minority Interest	Total
Balances January 1, 1932								
Company A	17,825							
Reserve Intercompany Profit January 1				400 *D*				
Adjusted Balance								17,425
Company B		12,605						
Eliminate 80% $8,000						6,400 *b*		
Minority 20% $12,605							2,521	
Consolidate 80% $4,605 Increase								3,684
Company C			4,600					
Eliminate 60% $4,600						2,760 *d*		
Minority 40% $4,600							1,840	
Net Profits for the Year	14,560	15,071	5,290					
Minority 20% Company B							3,014.20	
40% Company C							2,116	
Consolidate								25,066.40
	32,385	27,676	9,890				9,491.20	46,175.40
Deductions:								
Dividends Paid	5,000	4,500	1,600			4,560 *e*	1,540	5,000
Organization Expenses Amortized		500					100	400
Loss of Capital Assets*			2,350				940	1,410
Total Deductions	5,000	5,000	3,950				2,580	6,810
Balances, December 31, 1932	27,385	22,676	5,940				6,911.20	39,365.40
Surplus Reserves:								
Reserve for Sinking Fund	15,000							15,000.00
Reserve for Contingencies	3,000	1,000					200	3,800.00
Totals	45,385	23,676	5,940				7,111.20	58,165.40
Reserve for Intercompany Profit in Equipment								320.00
Holding Company's Surplus								57,845.40

*NOTE.—See Note 2 following Consolidated Surplus Statement, Illustration 52.

ILLUSTRATION 55

2. Dividends were declared June 20, payable July 10 to stockholders of record June 30, as follows: Company A, 10 per cent.; Company B, 15 per cent.; Company C, 8 per cent.

3. Bonds Payable are:

	TIME	RATE	INTEREST DATE
Company A	20 years	5%	Jan.–July
Company B	10 years	6%	April–Oct.
Company C	20 years	6%	May–Nov.

4. Company A owns $30,000 of the bonds of Company B and $20,000 of the bonds of Company C. Company B owns $10,000 of the bonds of Company C.

5. Company A's bonds were sold at 95. The discount is being accumulated on a straight-line basis.

6. Annual sinking fund requirements are: Company A, $15,000; Company C, $2,500. These are deposited January 1 and May 1, respectively.

7. Intercompany sales were:

Company B to Company A	$300,000
Company C to Company A	$100,000
Company C to Company B	$200,000

8. Inventories December 31, 1932:

Company A	$43,000
Company B	$55,000
Company C	$40,000

9. Intercompany profits in inventories December 31, 1932 were:

Company A	$2,500 profit to Company B
	$3,000 profit to Company C
Company B	$3,500 profit to Company C

10. On January 1, 1932 the inventory of Company A contained goods on which Company B had made a profit of $4,000 and goods on which Company C had made a profit of $1,200.

11. Accounts Receivable of Company C contain $40,000 due from Company A and $15,000 due from Company B.

12. Notes Receivable Discounted of Company C represents one $25,000 note issued by Company A in payment for goods purchased. There are no other intercompany notes.

13. Insurance unexpired, December 31, 1932:

Company A	$3,400
Company B	$4,100
Company C	$2,200

14. Depreciation on plant and equipment is 10 per cent. per annum.

COMPANY A AND SUBSIDIARY COMPANIES B AND C

Consolidated Balance Sheet Working Papers

December 31, 1932

	Balance Sheets			Adjustments		Eliminations	Consolidated Balance Sheet	
	Company A	Company B	Company C	Dr.	Cr.			
Assets								
Cash	9,905	22,571	6,360	1,000 K			39,836	
Customers	10,000	10,200	10,500			5,500 j	25,200	
Notes Receivable	6,000	3,500	3,000			2,500 k	10,000	
Advances to Subsidiaries	7,000				1,000 K	6,000 m		
Inventories	5,000	5,500	4,000				14,500	
Accrued Interest Receivable	65	85				150 g		
Investment in Company B	31,400							
Eliminate 80% $38,000						30,400 a		
Goodwill							1,000	G
Investment in Company C	14,500							
Eliminate 60% $24,600						14,760 c		
Goodwill (Negative)							260	*G
Bonds Owned	5,000	8,500				13,500 n		
Bond Sinking Fund	15,000						15,000	
Bond Discount	1,425						1,425	
Organization Expense		3,000	1,500				4,500	
Prepaid Insurance	340	410	220				970	
Plant and Equipment	40,000	28,000	35,000				103,000	
Land	2,500	3,800	1,000				7,300	
	148,135	85,566	61,580	1,000	1,000	72,810	222,471	

	Company A	Company B	Company C	Dr.	Cr.	Eliminations	Consolidated Balance Sheet	
Liabilities and Capital								
Accounts Payable	9,300	7,000	6,790			5,500 j	17,590	
Notes Payable	3,000						3,000	
Notes Receivable Discounted	1,000		2,500			2,500 k	1,000	
Advances from Company A		4,000	2,000			6,000 m		
Accrued Interest Payable	750	150	50			150 g	800	
Reserve for Depreciation	8,700	10,740	19,300	J 25 60			38,714 40	
Bonds Payable	30,000	10,000	5,000			13,500 n	31,500	
Capital Stock:								
Company A	50,000						50,000	
Company B		30,000						
Eliminate 80%						24,000 a		
Minority 20%							6,000	M
Company C			20,000					
Eliminate 60%						12,000 c		
Minority 40%							8,000	M
Reserve for Sinking Fund	15,000						15,000	SR
Reserve for Contingencies	3,000	1,000					{ 3,800 { 200	SR M
Surplus:								
Company A	27,385				J 25 60		27,410 60	S
Company B		22,670						
Minority 20%							4,535 20	M
Eliminate 80% $8,000						6,400 a		
Consolidate 80% $14,676 Increase							11,740 80	S
Company C			5,940					
Minority 40%							2,376	M
Eliminate 60% $4,600						2,760 c		
Consolidate 60% $1,340 Increase							804	S
	148,135	85,566	61,580	25 60	25 60	72,810	222,471 00	

*Negative Goodwill.

Illustration 56

15. On January 1, 1931, Company B sold certain equipment to Company A for $20,000. On this sale a profit of $4,000 was made. The asset is still carried in the plant account at $20,000.
16. On December 30, 1932, Company B forwarded to Company A a check for $10,000 in partial repayment of advances received from the parent company.
17. It has been the custom of Company B to write off each year $10,000 of its Organization Expense account balance.
18. Disregard all income tax computations.

COMPANIES A, B, AND C
TRIAL BALANCES
December 31, 1932

	Company A	Company B	Company C
Debits			
Cash	$ 99,050	$ 225,710	$ 63,600
Customers	100,000	102,000	105,000
Notes Receivable	60,000	35,000	30,000
Advances to Subsidiaries	70,000	. . . .	. . . .
Inventories	48,000	60,000	36,000
Plant and Equipment	400,000	280,000	350,000
Land	25,000	38,000	10,000
Investment in Company B	314,000	. . . .	. . . .
Investment in Company C	145,000	75,000	. . . .
Bonds Owned	50,000	10,000	. . . .
Bond Sinking Fund	150,000	. . . .	10,000
Bond Discount	7,125	. . . .	. . . .
Organization Expense	. . . .	35,000	15,000
Purchases	450,000	540,000	438,000
Selling Expenses	175,000	105,000	95,000
General Expense	130,800	121,200	83,000
Bond Interest	7,875	4,500	2,500
Insurance Prepaid	4,800	5,200	3,800
	$2,236,650	$1,636,610	$1,241,900
Credits			
Accounts Payable	$ 73,000	$ 70,000	$ 45,000
Notes Payable	50,000	. . . .	22,500
Advances from Company A	. . . .	40,000	20,000
Notes Receivable Discounted	10,000	. . . .	25,000
Bonds Payable	300,000	100,000	50,000
Reserve for Depreciation	55,000	85,000	165,000
Capital Stock	500,000	300,000	200,000
Reserve for Sinking Fund	150,000	. . . .	10,000
Reserve for Contingencies	30,000	10,000	. . . .
Surplus	120,000	80,000	6,500
Sales	896,200	946,310	697,500
Bond Interest Income	2,350	500	. . . .
Sinking Fund Income	4,500	. . . .	400
Dividends Received	45,600	4,800	. . . .
	$2,236,650	$1,636,610	$1,241,900

ILLUSTRATION 57

COMPANY A
BALANCE SHEET
December 31, 1932

Assets			
Current Assets:			
Cash		$ 99,050	
Customers		100,000	
Notes Receivable	$ 60,000		
Less Discounted Notes	10,000	50,000	
Inventory		43,000	
Accrued Interest Income		650	
Total Current Assets			$ 292,700
Fixed Assets:			
Plant and Equipment	$400,000		
Depreciation Reserve	95,000	$ 305,000	
Land		25,000	
Total Fixed Assets			330,000
Investments:			
Stock of Company B		$ 314,000	
Stock of Company C		145,000	
Bonds of Company B		30,000	
Bonds of Company C		20,000	
Advances to Subsidiaries		70,000	
Total Investments			579,000
Deferred and Prepaid Items:			
Unexpired Insurance		$ 3,400	
Bond Discount		6,750	
Total			10,150
Bond Sinking Fund			150,000
Total Assets			$1,361,850
Liabilities and Capital			
Current Liabilities:			
Accounts Payable		$ 73,000	
Notes Payable		50,000	
Accrued Bond Interest		7,500	
Total Current Liabilities			$ 130,500
Fixed Liabilities:			
Bonds Payable			300,000
Capital:			
Capital Stock		$ 500,000	
Surplus:			
Sinking Fund Reserve	$150,000		
Contingency Reserve	30,000		
Unappropriated	251,350	431,350	
Net Worth			931,350
Total Liabilities and Capital			$1,361,850

ILLUSTRATION 58

From the foregoing trial balances and additional data, will be prepared:

1. Balance Sheet of Company A (Illustration 58).
2. Statement of Profit and Loss of Company A (Illustration 59).
3. Consolidated Working Papers (Illustration 60.)
4. Consolidated Balance Sheet (Illustration 61).
5. Schedule of Minority Interests (Illustration 62).
6. Consolidated Statement of Profit and Loss (Illustration 63).
7. Consolidated Surplus Statement (Illustration 64).
8. Consolidated Profit and Loss Working Papers (Illustration 65).
9. Consolidated Cost of Goods Sold Working Papers (Illustration 66).
10. Consolidated Surplus Working Papers (Illustration 67).

COMPANY A

STATEMENT OF PROFIT AND LOSS

Year Ended December 31, 1932

Sales			$ 896,200
Less Cost of Goods Sold:			
Inventory, January 1	$ 48,000		
Purchases	450,000	$ 498,000	
Inventory, December 31,		43,000	
Cost of Goods Sold			455,000
Gross Profit on Sales			$ 441,200
Less Expenses:			
Selling Expense		$ 175,000	
General Expense		130,800	
Insurance		1,400	
Depreciation		40,000	347,200
Net Operating Profit			$ 94,000
Add Financial Income:			
Bond Interest		$ 3,000	
Sinking Fund Income		4,500	
Dividends Received		45,600	
Total		$ 53,100	
Less Financial Expense			
Bond Interest		15,750	37,350
Net Profit for the Year			$ 131,350

ILLUSTRATION 59

Explanation of Adjusting Entries:

A Intercompany dividends. It should be observed that the *consolidated surplus* has not been changed by the payment of dividends from Company C to Companies A and B and by Company B to Company A. (For the moment, the fact that the minority interest in Company B seems to benefit from Company C's

COMPANY A AND SUBSIDIARY COMPANIES B AND C

CONSOLIDATED WORKING PAPERS

Year Ended December 31, 1932

	Trial Balances			Adjustments		Eliminations	Profit and Loss		Consolidated Balance Sheet
	Company A	Company B	Company C						
Debits									
Cash	99,050	225,710	63,600						388,360
Customers	100,000	102,000	105,000			55,000g			252,000
Notes Receivable	60,000	35,000	30,000			25,000h			100,000
Advances to Subsidiaries	70,000				10,000K	60,000j			
Inventories	48,000	60,000	36,000				144,000		
Plant and Equipment	400,000	280,000	350,000						1,030,000
Land	25,000	38,000	10,000						73,000
Investment in Company B	314,000								
Eliminate 80% of									
Capital Stock						240,000a			
Surplus $80,000						64,000c			
Goodwill									10,000G
Investment in Company C	145,000								
Eliminate 60% of									
Capital Stock						120,000b			
Surplus $46,000						27,600d			
Goodwill (Negative)									2,600*G
Investment in Company C		75,000							
Eliminate 30% of									
Capital Stock						60,000b			
Surplus $30,000						9,000e			
Goodwill									6,000G
Bonds Owned	50,000	10,000				60,000k			
Bond Sinking Fund	150,000		10,000						160,000
Bond Discount	7,125				375C				6,750
Organization Expense		35,000	15,000		10,000L				40,000
Purchases	450,000	540,000	438,000			600,000f	828,000		
Selling Expenses	175,000	105,000	95,000				375,000		
General Expenses	130,800	121,200	83,000				335,000		
Bond Interest	7,875	4,500	2,500	9,875C		3,600m	21,150		
Insurance Prepaid	4,800	5,200	3,800		4,100G				9,700
	2,236,650	1,636,610	1,241,900						
Accrued Bond Interest	650	100		750B		750n			
Inventories, Dec. 31, 1932	43,000	55,000	40,000	138,000D					138,000
Insurance Expense	1,400	1,100	1,600	4,100G			4,100		
Depreciation Expense	40,000	28,000	35,000	103,000H	320M		102,680		
Cash in Transit	10,000			10,000K					10,000
Total Debit Eliminations						1,324,950			
Balance Sheet Total									2,221,210
Credits									
Accounts Payable	73,000	70,000	45,000			55,000g			133,000
Notes Payable	50,000		22,500						72,500
Advances from Company A		40,000	20,000			60,000j			
Notes Receivable Discounted	10,000		25,000			25,000h			10,000
Bonds Payable	300,000	100,000	50,000			60,000k			390,000
Reserve for Depreciation	55,000	85,000	165,000	320M	103,000H				407,680
Capital Stock:									
Company A	500,000								500,000
Company B		300,000							
Eliminate 80%						240,000a			
Minority 20%									60,000M
Company C			200,000						
Eliminate 90%						180,000b			
Minority 10%									20,000M
Surplus and Surplus Reserves:									
Company A	300,000			3,200J 3,200E	} 50,400A				344,000S
Company B		90,000		10,000L					
Eliminate 80% $80,000						64,000c			
Minority 20% $80,000									16,000M
Consolidate None									
Company C			16,500						
Eliminate 60% $46,000						27,600d			
30% $30,000						9,000e			
Minority 10% $16,500									1,650M
Consolidate 60% $29,500 Decrease									17,700S*
30% $13,500 Decrease									4,050S*
Sales	896,200	946,310	697,500			600,000f		1,940,010	
Bond Interest Income	2,350	500			750B	3,600m			
Sinking Fund Income	4,500		400					4,900	
Dividends Received	45,600	4,800		50,400A					
	2,236,650	1,636,610	1,241,900						
Accrued Bond Interest Payable	7,500	1,500	500		9,500C	750n			8,750
Inventories Dec. 31, 1932	43,000	55,000	40,000		138,000D			138,000	
Intercompany Profit in Inventories, Jan. 1, 1932	3,200				3,200E			3,200	
Reserve for Intercompany Profits in Inventories				7,850F	7,850F		7,850		7,850R
Reserve for Intercompany Profit in Equipment					3,200J				3,200R
				340,695	340,695				
Total Credit Eliminations						1,324,950			
							1,817,780	2,086,110	
Net Profit for the Year							268,330		
Minority Interest Company B									29,082M
Minority Interest Company C									4,630M
Holding Company's Share									234,618S
							2,086,110	2,086,110	2,221,210

*Negative amount.

NOTE.—The minority interest in current profits must be obtained, as has been indicated previously, from the statements of the subsidiary corporations or from profit and loss working papers as shown in Illustration 65.

ILLUSTRATION 60

dividend payment may be ignored.) These intercompany dividends are in no sense *income to the consolidation.* The surplus of Company A is wholly "consolidated surplus" and usually represents a major portion of the consolidated surplus. The items marked *S* in the Consolidated Balance Sheet column are consolidated surplus. As a matter of convenience the dividends received from subsidiaries are transferred to the consolidated surplus with the surplus of Company A.

B Set up accrued interest receivable on bonds owned.

C Set up accrued interest payable on bonds and amortize one-fortieth of bond discount.

D Set up inventories at December 31.

E Reduce surplus at January 1 and cost of goods sold during 1932 for intercompany profits in inventories at the beginning of the fiscal year (80% of \$4,000.) No provision is made for the \$1,200 profit earned by Company C because the transactions resulting in that profit were completed prior to Company A's acquiring control of Company C.

F Set up reserve for intercompany profits in inventories December 31, 1932, with a corresponding increase in the cost of goods sold during the year ended on that date.

80 per cent. of \$2,500 =	\$2,000
90 per cent. of \$6,500 =	5,850
Total	\$7,850

G To amortize Insurance Prepaid for the expense chargeable to 1932 operations.

H To charge expense with depreciation for the year.

J To set up reserve for intercompany profit in equipment, 80 per cent. of \$4,000.

K To set up cash in transit and to reduce advances to subsidiaries.

L To amortize \$10,000 of Company B's organization expense.

M Reduce depreciation expense by 10 per cent. of the \$3,200 intercompany profit in equipment, thus placing depreciation on a basis of "cost to the consolidation."

Explanation of Eliminations:

a–e inclusive. Intercompany ownership for book values acquired at dates of acquisitions.

f Sales—purchases.

g Receivables—payables.

h Notes receivable—notes receivable discounted.

j Advance accounts.

k Bonds owned—bonds payable. In lieu of eliminating the bonds owned, this amount may be carried to the Consolidated Balance

COMPANY A
(Subsidiary Companies B and C)
CONSOLIDATED BALANCE SHEET
December 31, 1932

Assets			
Cash		$ 398,360	
Customers		252,000	
Notes Receivable	$100,000		
Discounted Notes	10,000	90,000	
Inventories	$138,000		
Intercompany Profit Provision	7,850	130,150	
Total Current Assets			$ 870,510
Plant and Equipment	$1,030,000		
Intercompany Profit Provision	3,200	$1,026,800	
Reserve for Depreciation		407,680	
		$ 619,120	
Land		73,000	
Total Fixed Assets			692,120
Bond Sinking Fund			160,000
Bond Discount		$ 6,750	
Prepaid Insurance		9,700	
Organization Expense		40,000	
Total Deferred Items			56,450
Goodwill			13,400
Total Assets			$1,792,480
Liabilities and Capital			
Accounts Payable		$ 133,000	
Notes Payable		72,500	
Accrued Bond Interest Payable		8,750	
Total Current Liabilities			$ 214,250
Bonds Payable			390,000
Minority Interest (See Schedule, Illustration 62)			131,362
Capital Stock		$ 500,000	
Surplus (Including the holding company's share of appropriated surplus of the subsidiary companies)		406,868	
Reserve for Sinking Fund (Co. A)		150,000	
Total Net Worth			$1,056,868
Total Liabilities and Capital			$1,792,480

ILLUSTRATION 61

Sheet column. In such case, the bonds appear on the consolidated balance sheet as *treasury bonds* or as

Bonds Payable	$450,000	
Less Intercompany Holdings	60,000	
Outstanding in Hands of the Public		$390,000

m Bond interest income—bond interest expense.

n Accrued interest receivable—accrued interest payable.

SCHEDULE OF MINORITY INTERESTS
December 31, 1932

	TOTAL	COMPANY B	COMPANY C
Capital Stock	$ 80,000	$ 60,000	$ 20,000
Surplus	14,650	14,000	650
Reserve for Sinking Fund	1,000		1,000
Reserve for Contingencies	2,000	2,000	
Current Profits	33,712	29,082	4,630
Totals	$131,362	$105,082	$ 26,280

NOTE.—The preparation of this schedule requires an analysis of the records of the individual subsidiary companies.

ILLUSTRATION 62

COMPANY A
(Subsidiary Companies B and C)
CONSOLIDATED STATEMENT OF PROFIT AND LOSS
Year Ended December 31, 1932

Sales		$1,940,010
Less Cost of Goods Sold:		
Inventories, January 1	$ 140,800	
Purchases	828,000	
Goods Available for Sale	968,800	
Less Inventories, December 31	130,150	
Cost of Goods Sold		838,650
Gross Profit on Sales		$1,101,360
Less Expenses:		
Selling Expenses	$ 375,000	
General Expenses	335,000	
Insurance	4,100	
Depreciation	102,680	
Total		816,780
Operating Profit		$ 284,580
Less Net Financial Expense		
Bond Interest Expense	$ 21,150	
Sinking Fund Income	4,900	16,250
Net Profit for the Year		$ 268,330
Minority Interest:		
Company B	$ 29,082	
Company C	4,630	33,712
Holding Company's Share		$ 234,618

ILLUSTRATION 63

COMPANY A
(Subsidiary Companies B and C)
CONSOLIDATED SURPLUS STATEMENT
Year Ended December 31, 1932

Balance January 1, 1932		$395,600 (A)
Add Profit for the Year		234,618
		$630,218
Deduct:		
Dividends Paid	$50,000	
Organization Expenses	8,000	
Loss of Capital Assets	12,150 (B)	
Provision for Intercompeny Profit in Equipment	3,200	73,350
Balance December 31, 1932		$556,868 (C)

NOTE.—(*A*) Includes holding company's appropriated surplus and holding company's share of appropriated surplus of subsidiary companies. This opening balance is determined from the first three items in the surplus column of the working papers in Illustration 67.

(*B*) See note explaining a similar item in Illustration 52.

(*C*) Includes appropriated surplus. Theoretically the consolidation has no appropriations of surplus. These are restricted to the ledgers and statements of the individual corporations. Occasionally one finds an exception to this statement in the showing of the holding company's reserve for sinking fund on the *consolidated balance sheet* just as it would appear on the *balance sheet of the holding company*. See the consolidated balance sheet, Illustration 49, the holding company's balance sheet, Illustration 58, and the consolidated balance sheet, Illustration 61.

ILLUSTRATION 64

Alternative Working Papers.—In Illustrations 65, 66, and 67, are given alternative working papers. These forms are used principally when the consolidated statements are prepared from the financial statements (and other data) of the companies in the consolidation. It should be understood that these working papers are in lieu of, not in addition to, those shown in Illustrations 60. To be complete these illustrations should contain *consolidated balance sheet working papers*. The latter are omitted here because, for balance sheet accounts, they would be identical with the balance sheet items in the working papers Illustration 60.

Comments on Illustrative Problem 2:

The working papers contained in the solution to Problem 2 and resulting statements, Illustrations 58 to 67 inclusive, exhibit a conventional and customary treatment of the various factors involved in the preparation of consolidated statements. It has been the intention of the author to introduce a number of the intercompany items usually encountered by the practicing accountant. It will be realized that a practical case may produce additional detailed work without necessarily introducing additional principles. Depreciation, for example, has been handled in the problem through the use of a blanket reserve for all depreciable property. The practical case may involve several depreciation reserves each evaluating a particular kind of depreciable property such as buildings, equipment, or fixtures. The introduction of additional reserves would not alter the accounting principles set forth in the foregoing for the adjusting of intercompany profits in

COMPANY A AND SUBSIDIARY COMPANIES B AND C
CONSOLIDATED PROFIT AND LOSS WORKING PAPERS
Year Ended December 31, 1932

	Company A	Company B	Company C	Adjustments		Eliminations	Total
Sales	896,200	946,310	697,500			600,000*f*	1,940,010
Less Cost of Goods Sold*	455,000	545,000	434,000				838,650
Gross Margin	441,200	401,310	263,500				1,101,360
Less Expenses:							
Selling Expense	175,000	105,000	95,000				375,000
General Expense	130,800	121,200	83,000				335,000
Insurance	1,400	1,100	1,600				4,100
Depreciation	40,000	28,000	35,000		320*M*		102,680
Totals	347,200	255,300	214,600				816,780
Net Operating Profit	94,000	146,010	48,900				284,580
Add Other Income:							
Bond Interest	3,000	600				3,600*m*	
Sinking Fund Income	4,500		400				4,900
Dividends Received	45,600	4,800		50,400*A*			
Totals	147,100	151,410	49,300				289,480
Deduct Bond Interest Expense	15,750	6,000	3,000			3,600*m*	21,150
Net Profit for the Year	131,350	145,410	46,300				268,330
Minority Interests:							
Company B 20%		29,082					
Company C 10%			4,630				33,712
Holding Company's Share							234,618

*See Consolidated Cost of Goods Sold Working Papers, Illustration 66.

ILLUSTRATION 65

COMPANY A AND SUBSIDIARY COMPANIES B AND C
CONSOLIDATED COST OF GOODS SOLD WORKING PAPERS
Year Ended December 31, 1932

	Company A	Company B	Company C	Adjustments		Eliminations	Total
Inventories, January 1	48,000	60,000	36,000		3,200*E*		140,800
Purchases	450,000	540,000	438,000			600,000*f*	828,000
Total	498,000	600,000	474,000				968,800
Inventories, December 31	43,000	55,000	40,000	7,850*F*			130,150
Cost of Goods Sold	455,000	545,000	434,000				838,650

ILLUSTRATION 66

COMPANY A AND SUBSIDIARY COMPANIES B AND C—CONSOLIDATED SURPLUS WORKING PAPERS — Year Ended December 31, 193

	Company A	Company B	Company C	Adjustments		Eliminations	Minority	Surplus
Company A, January 1, 1932	*350,000							
Intercompany Profit in Inventories				3,200E				
Adjusted Balance								346,800
Company B, January 1, 1932		135,000						
Less 80% $80,000						64,000c		
Minority 20%							27,000	
Consolidate 80% $55,000 Increase								44,000
Company C, January 1, 1932			46,000					
Less 60% $46,000						27,600d		
30% $30,000						9,000e		
Minority 10%							4,600	
Consolidate 30% $16,000 Increase								4,800
Net Profits for 1932	131,350	145,410	46,300					234,618
Minority Interests								
Company B 20%							29,082	
Company C 10%							4,630	
Totals	481,350	280,410	92,300				65,312	630,218
Deductions:								
Dividends Paid	50,000	45,000	16,000		50,400A		10,600	50,000
Organization Expense Amortized		10,000					2,000	8,000
Loss of Capital Assets			13,500				1,350	12,150
Total Deductions	50,000	55,000	29,500				13,950	70,150
Balances, December 31, 1932	431,350	225,410	62,800					
Total Minority Interest							51,362	
								560,068
Reserve for Intercompany Profit in Equipment								3,200
Consolidated Surplus of Holding Company								556,868

*To shorten or condense the consolidated surplus working papers, accountants frequently combine all surplus reserves with the surplus account. The balance of Company A's surplus on January 1, 1932 ($350,000) appeared in the ledger as:

Surplus	$170,000
Sinking Fund Reserve	150,000
Reserve for Contingencies	30,000
Total	$350,000

The trial balance at December 31, 1932 reveals the same amounts except that surplus has been reduced by dividends in the amount of $50,000.

Similar analyses may be made of the working paper surpluses of Companies B and C.

ILLUSTRATION 67

fixed assets. Many of the items normally requiring adjustment (bad debts, supplies inventories, accrued interest on notes, etc.) have been omitted in order that attention might be focused more fully on the principles governing the preparation of consolidated statements. The adjustment for bad debts is not altered because of the consolidation. Rules governing the treatment of intercompany profits in inventories apply equally to inventories of merchandise, raw materials, goods-in-process, supplies, and all other inventories. Accrued interest payable (or receivable) is not unlike accrued interest on bonds payable (or owned), and on intercompany notes is treated just as it would be on intercompany bonds.

The solution shown is the one likely to be encountered in many practical cases. The reserve for intercompany profits may be set up for the full amount of the profit rather than for the holding company's share only. All too frequently one finds a more serious disregarding of certain phases of the minority interest. The reader may have wondered why the consolidated interest in Company C is stated as being 90 per cent. when Company A owns only 60 per cent. of the capital stock of that subsidiary company. The answer is found in the fact that the consolidated interest is often regarded as the total amount of *voting strength controlled either directly or indirectly* (through a third company) rather than the net worth actually allocable to the majority interest, that is, to the stockholders of the parent company. In the situation presented in the problem discussed, Company A may vote its 60 per cent. of Company C's stock and, likewise, through its ability to determine the policies of Company B (because of its 80-per-cent. ownership of Company B's stock), may vote Company B's holding of stock of Company C. Thus a 90-per-cent. voting control is established. The factors disregarded will now be considered.

Correction of Foregoing Solution:

The foregoing solution to Illustrative Problem No. 2 is weak, in the opinion of the author, in that it does not recognize the fact that the minority interest in Company B is affected by each change in the net worth of Company C. Legally, the minority interest in Company B owns one-fifth of that company—no more, no less. But this claim to one-fifth of Company B's net worth is obviously more valuable with any increase in the value of Company B's net assets.

Among the assets of Company B is an investment of $75,000, representing a three-tenths interest in another company, C. This $75,000 was paid for stock having a book value of $69,000 at the date of acquisition. According to the balance sheet of Company C at December 31, 1932, the net worth of that company is $262,800. Three-tenths of this is $78,840, the current value of Company B's investment in Company C. This indicates that a $9,840 increase has occurred, thereby increasing the net worth of Company B. It should not be overlooked that any increase in the net worth of Company B must result in an increase in the value of the holdings of the minority interest in Company B. It is, of course, impossible for either Company A or Company B to benefit from an increase in the net worth of Company C without sharing a portion of the increase with the minority stockholders of Company B.

A new schedule of minority interests may be prepared as shown in Illustration 68.

SCHEDULE OF MINORITY INTERESTS

	Total	Company B	Company C
Capital Stock	$ 80,000	$ 60,000	$ 20,000
Surplus	14,650	14,000	650
Sinking Fund Reserve	1,000		1,000
Reserve for Contingencies	2,000	2,000	
Increase in Value of Investment in Company C*	1,968	1,968	
Current Profits	33,712	29,082	4,630
	$133,330	$107,050	$ 26,280

*Increase in value of Company B's investment in Company C is $9,840. Twenty per cent. of this belongs to the minority interest in Company B. Or this increase may be determined:

Net Worth of Company C		$262,800
To Minority in Company B, 20% of 30% interest		$ 15,768
Purchase Price	$ 15,000	
Less Goodwill Bought	1,200	
Net Worth Acquired		13,800
Increase in Net Worth		$ 1,968

ILLUSTRATION 68

A second weakness in the statements results from the failure to recognize fully, not the present legal voting equity, but the practical economic equity of the minority interest in Company B. The January 1, 1932, inventory of Company A contained goods on which Company C had made a profit of $1,200. In preparing the consolidated balance sheet, Illustration 61, this gain was ignored, on the ground that it resulted from transactions completed prior to Company A's acquiring stock in Company C. It must be remembered, however, that Company B owned 30 per cent. of Company C at the time this profit was earned, and that Company B accordingly benefited in the amount of $360 (30% of $1,200). Company A, likewise, benefited through its ownership of an 80-per-cent. interest in Company B. The amount was $288 (80% of $360). It follows that the January 1, 1932, reservation of surplus for intercompany profits in inventories should have been $3,488 and not the $3,200 provided. Because of this error, the consolidation's net profit has been understated.

The amount of the reserve for intercompany profits in inventories at December 31, 1932, is in error and this error constitutes a third weakness in the solution of the problem. In computing the reserve, it was assumed that the consolidation's interest in Company C amounted to 90 per cent. It has been pointed out, however, that the minority interest in Company B "owns" 20 per cent. of Company B's 30-per-cent. interest in Company C. This means that the consolidated interest is 84 per cent., not 90 per cent. In following this line of reasoning, the reserve should be determined as follows:

80% of $2,500 profit to Company B	$2,000
84% of $6,500 profit to Company C	5,460
Total	$7,460

COMPANY A AND SUBSIDIARY COMPANIES B AND C—CONSOLIDATED SURPLUS WORKING PAPERS Year Ended December 31, 1932

	Company A	Company B	Company C	Adjustments		Eliminations	Minority	Surplus
Balances, January 1								
Company A	350,000							
Intercompany Profits in Inventories, January 1				3,488*E*				346,512
Company B		135,000						
Minority 20%							27,000	
80% $80,000 at Acquisition						64,000*c*		
Consolidate 80% $55,000 Increase								44,000
Company C			46,000					
Minority 16%							7,360	
60% of $46,000 at Acquisition						27,600*d*		
24% of $30,000 at Acquisition						7,200*e*		
Consolidate 24% of $16,000 Increase								3,840
Net Profit for the Year	131,350	145,410	46,300					232,518
Minority:								
Company B 20% of $145,410							29,082	
6% of $46,300							2,778	
Company C 10% of $46,300							4,630	
Totals	481,350	280,410	92,300				70,850	626,870
Deductions:								
Dividends Paid	50,000	45,000	16,000		50,400*A*		10,600	50,000
Organization Expense Amortized		10,000					2,000	8,000
Loss of Capital Assets			13,500				2,160	11,340
Total Deductions	50,000	55,000	29,500				14,760	69,340
Balances, December 31	431,350	225,410	62,800					557,530
Difference							56,090	
Deduct duplication resulting from Company B's reporting as income, dividends received from Company C: 6% $16,000							960	960
							55,130	558,490
Deduct duplication in surplus balances January 1, 1932, 6% of $30,000 surplus at acquisition							1,800	
Total Minority Interest in Surplus							53,330	
Reserve for Intercompany Profit in Equipment								3,200
Net Consolidated Surplus								555,290

ILLUSTRATION 69

This reserve is set up by debiting cost of goods sold (by reducing the closing inventories) and crediting the reserve. Because the reserve was overstated $390 ($7,850 − $7,460), the consolidated profit was understated in like amount.

The correcting of the errors just indicated may be summarized as follows:

Net Profit to Holding Company as per Consolidated Profit and Loss Working Papers, Illustration 65	$234,618
Add Adjustments of Reserves for Intercompany Profits in Inventories:	
Understatement January 1	288
Overstatement December 31	390
Adjusted Profit	$235,296
Deduct Share of Company C's Profits for Benefit of Minority Interest in Company B (20% of 30% of $46,300)	2,778
Holding Company's Profit	$232,518

The corrected Consolidated Surplus Working Papers are shown in Illustration 69.

The minority interest in a given company is entitled to a definite share of the profits (or losses) of that company as determined from the books of that company. In accordance with this principle, the minority interests in Companies B and C have been given:

20 per cent. of the $145,410 reported income of Company B	$29,082
10 per cent. of the $46,300 reported income of Company C	4,630
or a total of	$33,712
If Company B were carrying its investment at *current value* instead of at *original cost*, it would take up, at the end of 1932, 30 per cent. of the $46,300 earned by Company C, or $13,890. Since the holding company owns 80 per cent. of Company B, 20 per cent. of this $13,890 would accrue to the benefit of the minority interest in Company B. Accordingly, it is evident that the minority interest in Company B has benefited because of an increase in the net worth of Company C, even though this benefit has not been entered on the books of their company. This minority benefit amounts to 20 per cent. of 30 per cent. of $46,300 or	2,778
increasing the total minority interest to	$36,490
But if the investment were carried at current value, dividends received from Company C would be credited, not to income, but to the investment account. Actually Company B is carrying the investment at original cost and has reported as *income for 1932* (see trial balance, Illustration 57) the $4,800 in dividends received from Company C. As shown in the preceding paragraph, the minority interest in Company B was assigned 20 per cent. of the profit of $145,410, which included the $4,800 in question. This has resulted in a duplication of 6 per cent. (that is, 20% of 30%) of the $16,000 dividend or, described in another way, of 20 per cent. of $4,800 or	960
The actual minority profit is, therefore,	$35,530

The minority interest in current profits may be determined somewhat differently. It should be obvious that the actual interest of the minority should not be altered by the holding company's choice of method for carrying its investments. If the investments were carried at present value, Company B would report a net income for 1932 of $154,500, this amount being determined as follows:

Profit as Reported	$145,410
Less Dividend from Company C	4,800
Difference	$140,610
Add 30 per cent. of Company C's Net Profit of $46,300	13,890
Total	$154,500
Company B Minority Interest 20 per cent. of $154,500	$ 30,900
Company C Minority Interest 10 per cent. of $46,300	4,630
Total Minority Interest in Profits	$ 35,530

The method of accounting for the differences between the first and the second solutions to Illustrative Problem No. 2 is shown in Illustration 70. A corrected and condensed consolidated balance sheet is shown in Illustration 71.

RECONCILIATION OF SURPLUS

(To account for changes between first and second solutions to Illustrative problem No. 2)

December 31, 1932

Surplus per First Consolidated Balance Sheet (Illustration 61)			$556,868
Increases:			
Loss of Company C's Assets	First Basis	$ 12,150	
	Second Basis	11,340	810
Total			$557,678
Decreases:			
Provision for Intercompany Profits in Inventories, January 1	First Basis	$ 3,200	
	Second Basis	3,488	288
Share of $16,000 Increase in Surplus of Company C, January 1	First Basis	$ 4,800	
	Second Basis	3,840	960
Holding Company's Share of Profits in 1932	First Basis	$234,618	
	Second Basis	232,518	2,100
Total Decreases			$ 3,348
			$554,330
Adjustment for Duplication Resulting from Company B's Reporting Dividends from Company C as Income: 6% of $16,000			960
Surplus per Second Consolidated Balance Sheet (Illustration 71)			$555,290

ILLUSTRATION 70

32. Alternative Procedure.—It will be recalled that, early in the discussion of consolidated statements, mention was made of the fact that the holding corporation may carry its investment in either of two ways: (1) at the purchase price or (2) by taking up periodically the holding corporation's share of the losses or gains of the subsidiary. The preparation of the consolidated statements is probably no more difficult under one method than under the other. This is unquestionably

true so long as the problem is not complicated by the existence of subholding corporations. If the latter companies are a factor, the preparation of the consolidated statements seems to be facilitated if the investment accounts have been adjusted periodically for the losses and gains of the owned companies.

COMPANY A AND SUBSIDIARY COMPANIES B AND C
CONDENSED CONSOLIDATED BALANCE SHEET
December 31, 1932.

Total Assets per First Balance Sheet (Illustration 61)		$1,792,480
Add Increase due to Decreasing the Reserve for Intercompany Profits in Inventories, December 31, 1932		390
Total Assets		$1,792,870
Deduct Liabilities per First Balance Sheet (Illustration 61)		604,250
		$1,188,620
Minority Interest per Second Basis (Illustration 68)		133,330
Net Worth		$1,055,290
Capital Stock	$ 500,000	
Surplus	555,290	
Total	$1,055,290	

ILLUSTRATION 71

Those accountants who believe that the investment accounts should be carried at "current value according to the books of the subsidiary company" are quite likely to prepare consolidated statements, not in the manner followed in the foregoing discussion of Illustrative Problem No. 2, but by first adjusting the books of the various companies so that the investment accounts are stated at current values. The author believes that this procedure is a good one to follow, but he would point out that it is seldom, if ever, essential to the securing of correct results.

It is impossible to present a complete transcript of certain of the investment accounts shown in Illustrative Problem No. 2 as they would appear had they been adjusted periodically for the changes in the net worth of the subsidiaries. It is possible, however, to adjust the accounts so that they will reveal values current January 1, 1932, one year prior to the time at which the consolidated statements are to be prepared. This may be done as follows:

January 1, 1932

Company C:	
Capital Stock	$200,000
Surplus	46,000
Net Worth	$246,000
To Company A, 60%	$147,600
Company B, 30%	$ 73,800

Company A acquired its interest on this date and, therefore, $147,600 is the current value desired.

Company B acquired its interest on June 30, 1931, paying $75,000 for 30 per cent. of ($200,000+$30,000) or $69,000 of Company C's net worth. The price paid included a $6,000 payment for goodwill.

Net Worth January 1, 1932	$ 73,800
Net Worth June 30, 1931	69,000
Increase (Net)	$ 4,800

Company A acquired its interest in Company B on May 25, 1928, paying $314,000 for 80 per cent. of ($300,000+$80,000) or $304,000 of the subsidiary's net worth at date of acquisition. As has been indicated in the working papers, Illustration 60), the extra $10,000 is regarded as a payment for goodwill. The surplus of Company B, January 1, after the increase of the net worth of Company B has been taken account of is found as follows:

Surplus of Company B (per trial balance)	$ 80,000
Reserve for Contingencies	10,000
Add: Dividends Paid 1932	45,000
Balance per Books, January 1	$135,000
Add: Increase in Value of Investment in Company C (as above)	4,800
Adjusted Balance, January 1, 1932	$139,800

January 1, 1932

Company B:	
Capital Stock	$300,000
Surplus	139,800
Net Worth	$439,800
To Company A, 80%	$351,840
Net Worth January 1, 1932	$351,840
Net Worth May 25, 1928	304,000
Increase (Net)	$ 47,840

Entries to Adjust Investment Accounts:

Company A:

Investment in Company B	$ 47,840	
Surplus		$ 47,840

Company B:

Investment in Company C	4,800	
Surplus		4,800

Entries to Record Transactions in 1932:

Company A:

Cash	$ 45,600	
Investment in Company B		$36,000
Investment in Company C		9,600
For dividends received.		
Surplus	8,000	
Investment in Company B		8,000
For amortization of organization expense by Company B, $10,000.		
Surplus	8,100	
Investment in Company C		8,100
To take up 60% of loss of $13,500 in capital assets sustained by Company C.		
Surplus	3,240	
Investment in Company B		3,240
To take up 80% of $4,050 loss in value of Company B's assets, due to $13,500 loss in capital assets of Company C.		

Company B:

Cash	$ 4,800	
Investment in Company C		$ 4,800
For dividends received.		
Surplus	4,050	
Investment in Company C		4,050
To take up 30% of Company C's $13,500 loss of capital assets.		

Entries to Record Profits for 1932:

Company B:

Investment in Company C	$ 13,890	
Income from Subsidiaries		$ 13,890
To take up 30% of $46,300 profit of Company C.		

Company A:

Investment in Company C	$ 27,780	
Income from Subsidiaries		$ 27,780
To take up 60% of $46,300 profit of Company C.		
Investment in Company B	123,600	
Income from Subsidiaries		123,600
To take up 80% of profit of Company B:		
Company B $140,610*		
Company C (30%) . . 13,890		
Total $154,500		

*Note.—Company B's net profit according to its own books is $145,410. This includes as income a dividend of $4,800 received from Company C. This dividend is excluded from income (and credited to the investment account) if Company B takes up its 30 per cent. of Company C's earnings. $145,410 − $4,800 = $140,610.

The various investment account balances at December 31, 1932, may be determined as follows:

Company A:

Investment in Company B

Trial Balance	$314,000	Dividend	$ 36,000
Increase to January 1	47,840	Organization Expense	8,000
Profits	123,600	Decrease in Investments	3,240
		Balance	438,200
	$485,440		$485,440

Investment in Company C

Purchase Price	$145,000	Dividend	$ 9,600
Profits	27,780	Loss of Capital Assets	8,100
		Balance	155,080
	$172,780		$172,780

Company B:

Investment in Company C

Trial Balance	$ 75,000	Dividend	$ 4,800
Increase to January 1	4,800	Loss of Capital Assets	4,050
Profits	13,890	Balance	84,840
	$ 93,690		$ 93,690

The balance sheets of the respective companies will appear as in Illustration 72 after the posting of the entries indicated in the foregoing (and after the closing of the books). From these statements a consolidated balance sheet may be prepared. A duplication of all the working papers (Cost of Goods Sold, Profit and Loss, Surplus, and Balance Sheet) is not essential to a satisfactory illustration of this procedure. Accordingly, there are presented below only the net worth and investment account eliminations. These are presented first for working papers made directly from the balance sheets, Illustration 73.

It should be noted that the schedule of minority interests, Illustration 74, prepared from these working papers gives results identical with those indicated in the Consolidated Surplus Working Papers, Illustration 69, and the Schedule of Minority Interests, Illustration 68.

If the investment accounts have been adjusted from time to time to reflect changes in the subsidiaries' net worths, the trial balances at the end of a fiscal period will reveal the investments stated correctly for all items except the profit (or loss) for the year just ending and for such surplus changes as are customarily made at the end of the period. Examples of such changes are the writing off of goodwill and the amortizing of organization expense. Some companies follow the

practice of declaring dividends at this time. The working papers in skeleton form, Illustration 75, are prepared from the trial balances of the respective companies as they would appear at December 31 before closing.

Comments:

Adjustment A, Illustration 75. is offset by a credit to Organization Expense of Company B.

Adjustment B is offset by a debit to Surplus of Company A.

It should be observed that the consolidated goodwill remains constant throughout the various working papers.

From the working papers, Illustration 75, the same minority interest may be developed, as shown in Illustration 76.

BALANCE SHEETS COMPANIES A, B, AND C

	Company A	Company B	Company C
Assets			
Cash	$ 99,050	$ 225,710	$ 63,600
Customers	100,000	102,000	105,000
Notes Receivable	60,000	35,000	30,000
Advances to Subsidiaries	70,000	. . . .	. . . .
Inventories	43,000	55,000	40,000
Accrued Interest Earned	650	100	. . . .
Plant and Equipment (Net)	305,000	167,000	150,000
Land	25,000	38,000	10,000
Investment in Company B	438,200	. . . .	. . . .
Investment in Company C	155,080	84,840	. . . .
Bonds Owned	50,000	10,000	. . . .
Bond Sinking Fund	150,000	. . . .	10,000
Bond Discount	6,750	. . . .	. . . .
Organization Expense	. . . .	25,000	15,000
Insurance Prepaid	3,400	4,100	2,200
	$1,506,130	$ 746,750	$ 425,800
Liabilities and Capital			
Accounts Payable	$ 73,000	$ 70,000	$ 45,000
Notes Payable	50,000	. . . .	22,500
Notes Receivable Discounted	10,000	. . . .	25,000
Advances from Company A	. . . .	40,000	20,000
Accrued Interest Payable	7,500	1,500	500
Bonds Payable	300,000	100,000	50,000
Capital Stock	500,000	300,000	200,000
Surplus	385,630	225,250	52,800
Reserve for Sinking Fund	150,000	. . . .	10,000
Reserve for Contingencies	30,000	10,000	. . . .
	$1,506,130	$ 746,750	$ 425,800

NOTE.—The procedure involved in determining the above surplus balances (both free and appropriated) of Companies A and B is set forth in detail in the reconciliations in Illustrations 77 and 79.

ILLUSTRATION 72

COMPANY A AND SUBSIDIARY COMPANIES B AND C
CONSOLIDATED BALANCE SHEET WORKING PAPERS (SKELETON)
December 31, 1932

	Balance Sheets			Adjustments		Eliminations	Consolidated Balance Sheet
	Company A	Company B	Company C	Dr.	Cr.		
Debits							
Investment in Company B	438,200						
Eliminate 80%							
Surplus $225,250						180,200c	
Reserve for Contingencies $10,000						8,000c	
Capital Stock $300,000						240,000a	
Goodwill							10,000G
Investment in Company C	155,080						
Eliminate 60%							
Surplus $52,800						31,680d	
Reserve for Sinking Fund $10,000						6,000d	
Capital Stock $200,000						120,000b	
Goodwill (Negative)							2,600*G
Investment in Company C		84,840					
Eliminate 30%							
Surplus $52,800						15,840d	
Reserve for Sinking Fund						3,000d	
Capital Stock $200,000						60,000b	
Goodwill							6,000G
						664,720	
Credits							
Capital Stock							
Company A	500,000						500,000
Company B		300,000					
Eliminate 80%						240,000a	
Minority 20%							60,000M
Company C			200,000				
Eliminate 90%						180,000b	
Minority 10%							20,000M
Surplus and Surplus Reserves:							
Company A:							
Surplus	385,630						385,630S
Sinking Fund Reserve	150,000						150,000S
Contingency Reserve	30,000						30,000S
Company B:							
Surplus		225,250					
Contingency Reserve		10,000					
Minority Interest 20%							47,050M
Eliminate 80%						188,200c	
Company C:							
Surplus			52,800				
Sinking Fund Reserve			10,000				
Minority Interest 10%							6,280M
Eliminate 90%						56,520d	
						664,720	

*Negative.

ILLUSTRATION 73

SCHEDULE OF MINORITY INTERESTS—December 31, 1932

	Total	Company B	Company C
Capital Stock	$ 80,000	$ 60,000	$20,000
Surplus and Surplus Reserves	53,330	47,050	6,280
Totals	$133,330	$107,050	$ 26,280

Illustration 74

COMPANY A AND SUBSIDIARY COMPANIES B AND C

Consolidated Working Papers (Skeleton)—Year Ended December 31, 1932

	Trial Balances			Adjustments		Eliminations	Consolidated Balance Sheet
	Company A	Company B	Company C	Dr.	Cr.		
Debits							
Investment in Company B	322,600				8,000*B*		
Eliminate 80%							
Capital Stock						240,000*a*	
Surplus $70,750						56,600*c*	
Contingency Reserve $10,000						8,000*c*	
Goodwill							10,000*G*
Investment in Company C	127,300						
Eliminate 60%							
Capital Stock						120,000*b*	
Surplus $6,500						3,900*d*	
Sinking Fund Reserve $10,000						6,000*d*	
Goodwill							2,600**G*
Investment in Company C		70,950					
Eliminate 30%							
Capital Stock						60,000*b*	
Surplus $6,500						1,950*d*	
Sinking Fund Reserve $10,000						3,000*d*	
Goodwill							6,000*G*
						499,450	
Credits							
Capital Stock:							
Company B		300,000					
Eliminate 80%						240,000*a*	
Minority 20%							60,000*M*
Company C			200,000				
Eliminate 90%						180,000*b*	
Minority 10%							20,000*M*
Surplus and Reserves:							
Company B:							
Surplus		80,750		10,000*A*			
Contingency Reserve		10,000					
Minority 20% $80,750							16,150*M*
Eliminate 80%						64,600*c*	
Company C:							
Surplus			6,500				
Sinking Fund Reserve			10,000				
Minority 10%							1,650*M*
Eliminate 90%						14,850*d*	
Net Profit for 1932:							
Company C $46,300							38,892*S*
Minority 16%							7,408*M*
Company B $140,610							112,488*S*
Minority 20%							28,122*M*
						499,450	

*Negative.

Illustration 75

SCHEDULE OF MINORITY INTERESTS

December 31, 1932

	Total	Company B	Company C
Capital Stock	$ 80,000	$ 60,000	$ 20,000
Surplus and Surplus Reserves	17,800	16,150	1,650
Current Profits of:			
Company C	7,408	2,778	4,630
Company B	28,122	28,122	
Totals	$133,330	$107,050	$ 26,280

Illustration 76

When the investments in subsidiary companies were all carried at cost, the surplus accounts of Company A revealed a credit balance of $350,000 on January 1, 1932. According to the balance sheet of Company A on December 31, 1932, prepared under the assumption that investment accounts have been adjusted to current values, the surplus accounts reveal total credits of $565,630. The reconciliation of these two balances is shown in Illustration 77.

COMPANY A

Reconciliation of Surplus

Year Ended December 31, 1932

Balance January 1, per Books		$350,000
Add Increases in Investment Balances January 1:		
Company B		47,840
Total		$397,840
Deduct Decreases in Investment Balances 1932:		
Company B	$ 3,240	
Company C	8,100	11,340
Adjusted Balance		$386,500
Add: Profit per Books (Investments at Cost)	$131,350	
Less Dividends Received	45,600	85,750
Share of Profits of Subsidiaries:		
Company B, 80% $140,610	$112,488	
Company C, 84% $46,300	38,892	151,380
Total		$623,630
Deduct:		
Amortization of Organization Expense by Company B, 80% $10,000	$ 8,000	
Dividends Paid	50,000	58,000
Balance December 31, per Books		$565,630

Illustration 77

A further reconciliation should be introduced at this time to explain the discrepancy between the consolidated surplus of $552,290 obtained from the work-

ing papers, Illustration 69, and the amount $565,630 indicated in Illustration 77. The latter amount is the surplus of Company A—*not the consolidated surplus* at December 31. It must be adjusted for intercompany profits as shown in Illustration 78.

Reconciliation of Surplus
December 31, 1932

Balance per Books of Company A		$565,630
Add Increase in Net Profit Resulting from adjusting Depreciation Expense on Equipment sold to Company A by Company B		
10% $20,000 (Cost to Company A)	$ 2,000	
10% $16,800 (Cost to Consolidation)	1,680	320
Adjusted Balance		$565,950
Deduct Provision for Intercompany profits December 31, 1932, in:		
Equipment	$ 3,200	
Inventories (see page 116)	7,460	10,660
Balance of Consolidated Surplus		$555,290

Illustration 78

The surplus accounts of Company B may be reconciled in a manner similar to that employed for Company A, as shown in Illustration 79.

COMPANY B
Reconciliation of Surplus
Year Ended December 31, 1932

Balance January 1, per Books		$135,000
Add Increase in Value of Investment in Company C		4,800
Total		$139,800
Deduct Decrease in Value of Investment in Company C	$ 4,050	
Dividends Paid	45,000	
Organization Expense Amortized	10,000	
Total Deductions		59,050
		$ 80,750
Add: Net Profit (Investment at Cost)	$145,410	
Deduct Dividends Received	4,800	140,610
Share of Profits of Company C 30% $46,300		13,890
Balance December 31, per Books		$235,250

Illustration 79

The foregoing discussion has demonstrated that, when investment accounts are carried at cost, consolidated statements may be prepared (1) by working directly from the investment balances as stated, or (2) by first adjusting the investment accounts to reflect current values and then working from the respective adjusted

balances. One other procedure should be indicated briefly. It is possible that the accountant may work directly from the balances with the investments at cost and then convince his clients of the desirability of adopting the procedure of carrying the investments at current values. In such case, the adjustment of the investment accounts would be made *after* the preparation of the consolidated statements and not (as was done in the foregoing illustration) as a part of the work of preparing the consolidated statements. If the clients (Company A and Subsidiaries) wish to begin the year 1933 with the investment accounts stated on the current basis, the respective investment and surplus accounts should be increased in accordance with the following computations:

Books of Company B:

Net Worth of Company C:		
Capital Stock	$200,000	
Surplus	62,800	
Total		$262,800
30% of Same		$ 78,840
Investment of Company B in Company C	$ 75,000	
Goodwill Purchased	6,000	
Net Worth Purchased		69,000
Net Increase in Value of Investment		$ 9,840

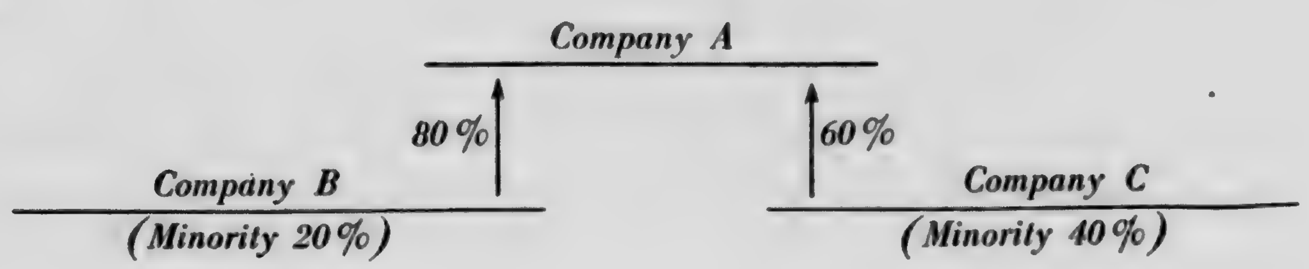
Books of Company A:

Net Worth of Company C:		$262,800
60% of Same		$157,680
Investment of Company A in Company C	$145,000	
Negative Goodwill	2,600	
Net Worth Purchased		147,600
Net Increase in Value of Investment		$ 10,080
Net Worth of Company B:		
Capital Stock	$300,000	
Surplus	225,410	
Increase in Value of Investment in Company C	9,840	
Total		$535,250
80% of Same		$428,200
Investment of Company A in Company B	$314,000	
Goodwill Purchased	10,000	
Net Worth Purchased		304,000
Net Increase in Value of Investment		$124,200

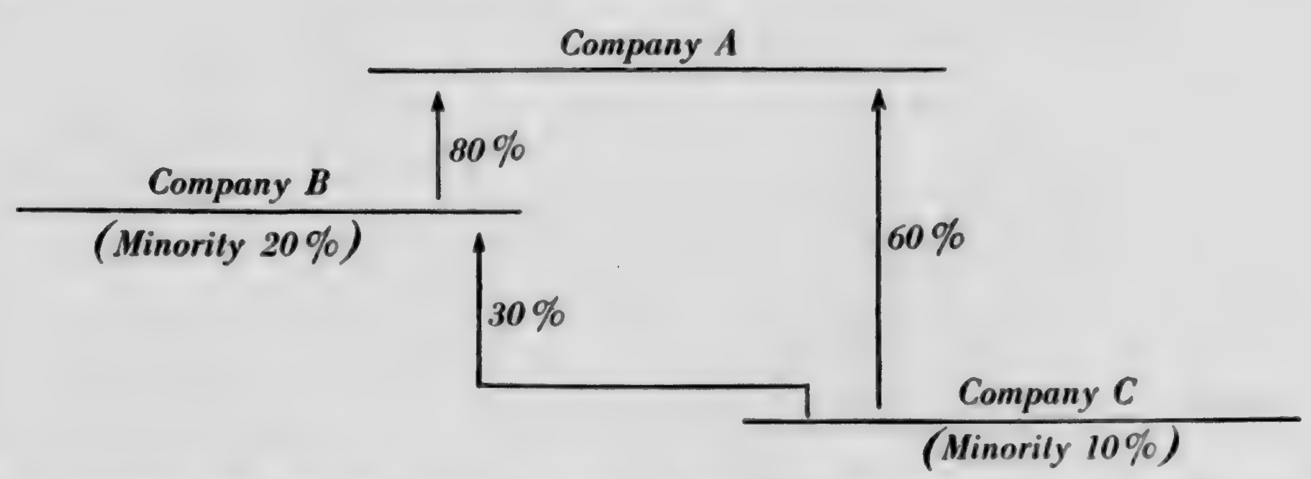
33. Illustrative Problem, No. 3.—The situations covered in the preceding Illustrative Problems, 1 and 2, may be illustrated by the diagrams in Illustration 80.

A third situation is frequently uncountered. It obtains when the holding corporation has control of one subsidiary not by direct ownership of a majority of the stock of that subsidiary but by having control of a second subsidiary which does own a majority of the stock of the first subsidiary. This may be diagrammed

Problem 1:



Problem 2:



NOTE.—In Problem 2, the minority group in Company B has an indirect interest of 6 per cent. in Company C.

ILLUSTRATION 80

as in Illustration 81. This Illustration shows that the minority group in Company B has an indirect interest of 12 per cent. in Company C. For Problem 3 the material used in Problem 2 has been altered to be representative of the third situation outlined. It is believed that the reader's familiarity with this material will facilitate his understanding the procedures here set forth.

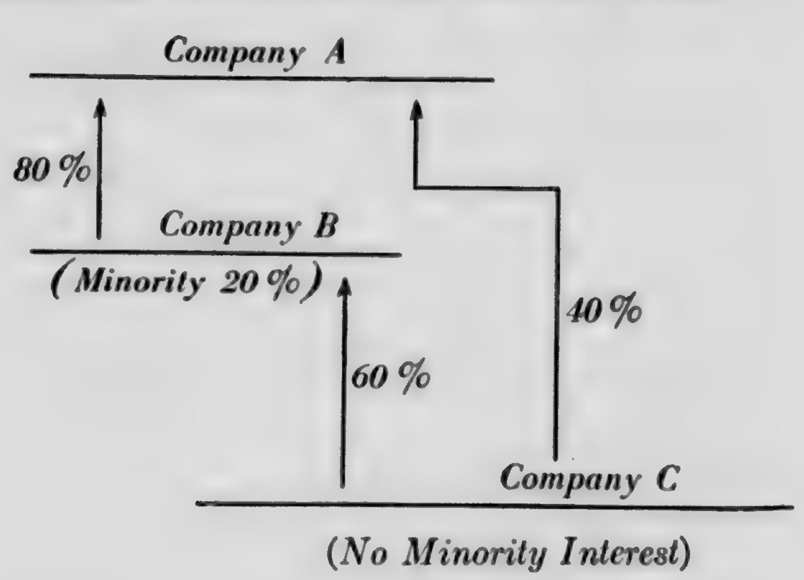


ILLUSTRATION 81

The trial balances of Companies A, B, and C at December 31, 1932, are shown in Illustration 82, and certain supplementary data follow.

COMPANIES A, B, AND C

Trial Balances, December 31, 1932

	Company A	Company B	Company C
Debits			
Cash	$ 99,050	$ 225,710	$ 63,600
Customers	90,000	82,000	105,000
Notes Receivable	40,000	20,000	30,000
Advances to Subsidiaries	70,000	. . . .	. . . .
Inventories	48,000	60,000	36,000
Fixtures and Equipment	100,000	80,000	100,000
Buildings	300,000	200,000	250,000
Land	25,000	18,000	10,000
Investment in Company B	314,000	. . . .	. . . .
Investment in Company C	90,000	175,000	. . . .
Bonds Owned	50,000	10,000	. . . .
Bond Sinking Fund	150,000	. . . .	10,000
Organization Expense	50,000	10,000	15,000
Bond Discount	7,125	. . . .	. . . .
Purchases	450,000	540,000	400,000
Salesmen's Salaries	100,000	50,000	52,000
Delivery Expense	15,000	20,000	18,000
Advertising	60,000	35,000	25,000
General Expense	90,000	65,000	60,000
Freight Inward	22,000	. . . .	38,000
Insurance Prepaid	4,800	5,200	3,800
Sales Returns and Allowances	8,500	10,000	7,000
Rent	. . . .	40,000	. . . .
Heat and Light	30,000	20,000	22,000
Donations	1,200	1,000	1,000
Bond Interest	7,875	4,500	2,500
	$2,222,550	$1,671,410	$1,248,900
Credits			
Accounts Payable	$ 60,000	$ 90,000	$ 45,000
Notes Payable	50,000	. . . .	22,500
Advances from Company A	. . . .	40,000	20,000
Notes Receivable Discounted	10,000	. . . .	25,000
Bonds Payable	300,000	100,000	50,000
Reserve for Depreciation, Fixtures	25,000	35,000	40,000
Reserve for Depreciation, Buildings	30,000	50,000	125,000
Capital Stock	500,000	300,000	200,000
Reserve for Sinking Fund	150,000	. . . .	10,000
Reserve for Contingencies	30,000	10,000	. . . .
Surplus	120,000	80,000	6,500
Sales	900,000	950,000	700,000
Purchase Discounts	2,200	6,000	4,500
Interest Income	2,500	310	. . . .
Bond Interest Income	2,350	500	. . . .
Dividends	36,000	9,600	. . . .
Sinking Fund Income	4,500	. . . .	400
	$2,222,550	$1,671,410	$1,248,900

ILLUSTRATION 82

Additional Data:

1. Investments in other companies are carried at cost. Company A's investment in Company B represents an 80-per-cent. inter-

est purchased May 5, 1928, when that company had capital stock of $300,000 and surplus of $80,000. Company A's investment in Company C represents a 40-per-cent. interest acquired July 1, 1932, when that company had capital stock of $200,000 and surplus of $30,000. The investment of Company B in Company C represents a 60-per-cent. interest obtained December 31, 1930, when that company had capital stock of $200,000 and surplus of $50,000.

2. Bonds Payable are:

	Time	Rate	Interest Date
Company A	20 years	5%	Jan.–July
Company B	10 years	6%	Aug.–Oct.
Company C	20 years	6%	May–Nov.

3. Company A owns $30,000 of the bonds of Company B and $20,000 of the bonds of Company C. Company B owns $10,000 of the bonds of Company C.
4. Company A's bonds were sold at 95. The discount is being accumulated on a straight-line basis.
5. Annual sinking fund requirements are: Company A, $15,000; Company C, $2,500. These are deposited January 1, and May 1, respectively.
6. Dividends were declared June 20, and paid July 5 to stockholders of record June 20, as follows: Company A, 10 per cent.; Company B, 15 per cent.; Company C, 8 per cent.
7. Intercompany sales were:

Company B to Company A	$300,000
Company C to Company B	$200,000
Company C to Company A	$100,000

8. Inventories December 31, 1932:

Company A	$43,000
Company B	$55,000
Company C	$40,000

9. Intercompany profits in inventories December 31, 1932:

Company A	$2,500 profit to Company B
	$3,000 profit to Company C
Company B	$3,500 profit to Company C

10. On January 1, 1932, the inventory of Company A contained goods on which Company B had made a profit of $4,000 and goods on which Company C had made a profit of $1,200.
11. Accounts Receivable of Company C contain $40,000 due from Company A and $15,000 due from Company B.

12. Notes Receivable Discounted of Company C represents one $25,000 note issued by Company A in payment for goods purchased. There are no other intercompany notes.
13. Insurance unexpired December 31, 1932:

Company A	$3,400
Company B	$4,100
Company C	$2,200

14. Depreciation rates:

Fixtures and Equipment	12½ per cent.
Buildings	5 per cent.

15. On January 1, 1931, Company B sold certain fixtures to Company A for $20,000. On this sale, a profit of $4,000 was made. The asset is still carried on the plant account at $20,000.
16. It has been the custom of Company B to write off each year $5,000 of its Organization Expense.
17. On December 30, 1932, Company B forwarded to Company A a check for $10,000 in partial payment of advances received.
18. Disregard all income tax computations.

From the foregoing trial balances, Illustration 82, and additional data, the following will be prepared:

1. Profit and Loss Statement of Company A (Illustration 83).
2. Balance Sheet of Company A (Illustration 84).
3. Balance Sheet of Company B (Illustration 85).
4. Profit and Loss Statement of Company C (Illustration 86).
5. Consolidated Working Papers (Illustration 87).
6. Consolidated Balance Sheet (Illustration 88).
7. Schedule of Minority Interest (Illustration 89).
8. Consolidated Statement of Profit and Loss (Illustration 90).

Explanation of Adjusting Entries:

A Amortize $5,000 of Company B's organization expense.

B Amortize prepaid insurance to set up value of these premiums at end of year.

C Annual provision for depreciation of fixtures, equipment, and buildings.

D Set up cash in transit and to reduce advances to subsidiaries.

E Accrue interest receivable on bonds owned.

F Accrue interest payable on bonds issued and to accumulate bond discount applicable to last six months of 1932.

G Inventories at end of fiscal period.

H Remove intercompany dividends from current consolidated income.

COMPANY A

STATEMENT OF PROFIT AND LOSS

Year Ended December 31, 1932

Gross Sales		$900,000	
Less Sales Returns and Allowances		8,500	
Net Sales			$891,500
Less Cost of Goods Sold:			
Inventory January 1, 1932		$ 48,000	
Purchases	$450,000		
Add Freight Inward	22,000	472,000	
Goods Available for Sale		$520,000	
Less Inventory December 31, 1932		43,000	
Cost of Goods Sold			477,000
Gross Profit on Sales			$414,500
Less Selling and Administrative Expense:			
Salesmen's Salaries		$100,000	
Delivery Expense		15,000	
Advertising		60,000	
Insurance		1,400	
General Expense		90,000	
Heat and Light		30,000	
Donations		1,200	
Depreciation		27,500	325,100
Net Operating Profit			$ 89,400
Add Net Financial Income:			
Income:			
Purchase Discounts		$ 2,200	
Interest Income		2,500	
Bond Interest Income		3,000	
Dividends		36,000	
Sinking Fund Income		4,500	
Total		$ 48,200	
Expense:			
Bond Interest		15,750	32,450
Net Profit for the Year			$121,850

ILLUSTRATION 83

COMPANY A

BALANCE SHEET

December 31, 1932

Assets			
Current Assets:			
Cash		$ 99,050	
Customers		90,000	
Notes Receivable	$ 40,000		
Discounted Notes	10,000	30,000	
Inventories		43,000	
Accrued Interest Earned		650	
Total Current Assets			$262,700
Fixed Assets:			
Fixtures and Equipment	$100,000		
Depreciation Reserve	37,500	$ 62,500	
Buildings	$300,000		
Depreciation Reserve	45,000	255,000	
Land		25,000	
Total Fixed Assets			342,500
Investments:			
Stock of Company B		$314,000	
Stock of Company C		90,000	
Advances to Subsidiaries		70,000	
Bonds of Subsidiaries		50,000	
Total			524,000
Deferred and Prepaid Items:			
Insurance Unexpired		$ 3,400	
Bond Discount		6,750	
Organization Expense		50,000	
Total			60,150
Bond Sinking Fund			150,000
Total Assets			$1,339,350
Liabilities and Capital			
Current Liabilities:			
Accounts Payable		$ 60,000	
Notes Payable		50,000	
Accrued Interest Payable		7,500	
Total Current Liabilities			$117,500
Fixed Liabilities:			
Bonds Payable			300,000
Capital:			
Capital Stock		$500,000	
Surplus:			
Reserve for Sinking Fund	$150,000		
Reserve for Contingencies	30,000		
Unappropriated	241,850	421,850	
Total Net Worth			921,850
Total Liabilities and Capital			$1,339,350

ILLUSTRATION 84

COMPANY B

BALANCE SHEET

December 31, 1932

Assets			
Current Assets:			
Cash		$225,710	
Customers		82,000	
Notes Receivable		20,000	
Inventories		55,000	
Accrued Interest Earned		100	
Total Current Assets			$382,810
Fixed Assets:			
Fixtures and Equipment	$ 80,000		
Depreciation Reserve	45,000	$ 35,000	
Buildings	$200,000		
Depreciation Reserve	60,000	140,000	
Land		18,000	
Total Fixed Assets			193,000
Investments:			
Stock of Company C		$175,000	
Bonds of Company C		10,000	
Total Investments			185,000
Deferred and Prepaid Items:			
Prepaid Insurance		$ 4,100	
Organization Expense		5,000	
Total			9,100
			$769,910
Liabilities and Capital			
Current Liabilities:			
Accounts Payable		$ 90,000	
Advances from Company A		40,000	
Accrued Bond Interest		1,500	
Total Current Liabilities			$131,500
Fixed Liabilities:			
Bonds Payable			100,000
Net Worth:			
Capital Stock		$300,000	
Surplus:			
Reserve for Contingencies	$ 10,000		
Unappropriated	75,000		
Profit of Period	153,410	238,410	
Total Net Worth			538,410
			$769,910

ILLUSTRATION 85

COMPANIES A, B, AND C
Consolidated Working Papers
December 31, 1932

	Trial Balances			Adjustments		Eliminations	Profit and Loss		Consolidated Balance Sheet
	Company A	Company B	Company C	Dr.	Cr.		Dr.	Cr.	
Debits									
Cash	99,050	225,710	63,600						388,360
Customers	90,000	82,000	105,000			55,000*h*			222,000
Notes Receivable	40,000	20,000	30,000			25,000*i*			65,000
Advances to Subsidiaries	70,000				10,000*D*	60,000*j*			
Inventories	48,000	60,000	36,000				144,000		
Fixtures and Equipment	100,000	80,000	100,000						280,000
Buildings	300,000	200,000	250,000						750,000
Land	25,000	18,000	10,000						53,000
Investment in Company B	314,000								
Eliminate 80% of Capital Stock						240,000*a*			
Eliminate 80% of Surplus $80,000						64,000*b*			10,000*G*
Investment in Company C	90,000								
Eliminate 40% of Capital Stock						80,000*c*			
Eliminate 40% of Surplus $30,000						12,000*d*			2,000**G*
Investment in Company C		175,000							
Eliminate 60% of Capital Stock						120,000*c*			
Eliminate 60% of Surplus $50,000						30,000*e*			25,000*G*
Bonds Owned	50,000	10,000				60,000*f*			
Bond Sinking Fund	150,000		10,000						160,000
Organization Expense	50,000	10,000	15,000		5,000*A*				70,000
Bond Discount	7,125				375*F*				6,750
Purchases	450,000	540,000	400,000			600,000*g*	790,000		
Salesmen's Salaries	100,000	50,000	52,000				202,000		
Delivery Expense	15,000	20,000	18,000				53,000		
Advertising	60,000	35,000	25,000				120,000		
General Expense	90,000	65,000	60,000				215,000		
Freight Inward	22,000		38,000				60,000		
Insurance Prepaid	4,800	5,200	3,800		4,100*B*				9,700
Sales Returns and Allowances	8,500	10,000	7,000				25,500		
Rent		40,000					40,000		
Heat and Light	30,000	20,000	22,000				72,000		
Donations	1,200	1,000	1,000				3,200		
Bond Interest	7,875	4,500	2,500	9,875*F*		3,600*k*	21,150		
	2,222,550	1,671,410	1,248,900						
Insurance Expense	1,400	1,100	1,600	4,100*B*			4,100		
Depreciation Expense	27,500	20,000	25,000	72,500*C*	400*M*		72,100		
Cash in Transit	10,000			10,000*D*					10,000
Accrued Bond Interest	650	100		750*E*		750*m*			
Inventories, December 31, 1932	43,000	55,000	40,000	138,000*G*					138,000
Total Debit Eliminations						1,350,350			
Balance Sheet Total									2,185,810
Credits									
Accounts Payable	60,000	90,000	45,000			55,000*h*			140,000
Notes Payable	50,000		22,500						72,500
Advances from Company A		40,000	20,000			60,000*j*			
Notes Receivable Discounted	10,000		25,000			25,000*i*			10,000
Bonds Payable	300,000	100,000	50,000			60,000*f*			390,000
Reserve for Depreciation, Fixtures	25,000	35,000	40,000	400*M*	35,000*C*				134,600
Reserve for Depreciation, Buildings	30,000	50,000	125,000		37,500*C*				242,500
Capital Stock:									
Company A	500,000								500,000
Company B		300,000							
Eliminate 80%						240,000*a*			
Minority Interest									60,000*M*
Company C			200,000						
Eliminate 100%						200,000*c*			
Surplus and Reserves:									
Company A:									
Surplus	120,000			{ 3,200*K* 3,776*I*	45,600*H*				158,624*S*
Reserve for Sinking Fund	150,000								150,000*S*
Reserve for Contingencies	30,000								30,000*S*
Company B:									
Surplus		80,000		5,000*A*					
Eliminate 80% $80,000 Acquired						64,000*b*			
Minority 20% $75,000									15,000*M*
Consolidate 80% $5,000 Decrease									4,000**S*
Reserve for Contingencies		10,000							
Minority 20%									2,000*M*
Consolidate 80%									8,000*S*
Company C:									
Surplus			6,500						
Eliminate 60% $50,000 Acquired						30,000*e*			
Eliminate 40% $30,000 Acquired						12,000*d*			
Minority 12% $43,500 Decrease									5,220**M*
Consolidate									30,280**S*
Reserve for Sinking Fund			10,000						
Minority 12%									1,200*M*
Consolidate 88%									8,800*S*
Sales	900,000	950,000	700,000			600,000*g*		1,950,000	
Purchase Discounts	2,200	6,000	4,500					12,700	
Interest Income	2,500	310						2,810	
Bond Interest Income	2,350	500			750*E*	3,600*k*			
Dividends	36,000	9,600		45,600*H*					
Sinking Fund Income	4,500		400					4,900	
	2,222,550	1,671,410	1,248,900						
Accrued Bond Interest Payable	7,500	1,500	500		9,500*F*	750*m*			8,750
Inventories, December 31, 1932	43,000	55,000	40,000		138,000*G*			138,000	
Inventories, January 1, 1932, Profit Reserve	3,776				3,776*I*			3,776	
Reserve Intercompany Profit in Inventories				7,720*J*	7,720*J*		7,720		7,720*R*
Reserve Intercompany Profit in Equipment					3,200*K*				3,200*R*
				300,921	300,921				
Total Credit Eliminations						1,350,350			
							1,829,770	2,112,186	
Net Profit for the Year							282,416		
Minority Interest:									
20% of Company B's $153,410									30,682*M*
12% of Company C's $56,300									6,756*M*
Holding Company's Share									244,978*S*
							2,112,186	2,112,186	2,185,810

*Negative amount

Illustration 87

73207

I Intercompany profit in inventories, January 1, 1932, 80 per cent. of \$4,000. An adjustment is made also for the profit of \$1,200 realized by Company C *even though the sale was completed prior to the acquisition of C's stock by A*. This is because Company A in owning 80 per cent. of Company B took up a share of this profit when this profit increased Company B's profits from Company C: 80 per cent. of 60 per cent. of \$1,200 is \$576.

J Intercompany profit in inventories December 31, 1932:

80% of \$2,500 =	\$2,000
\$3,000 − (20% of 60% of \$3,000) =	2,640
\$3,500 − (20% of 60% of \$3,500) =	3,080
Total	\$7,720

The above computation is designed to show that only that part of Company C's profits which belongs to the minority inter-

COMPANY C

STATEMENT OF PROFIT AND LOSS

Year Ended December 31, 1932

Gross Sales		\$700,000	
Less Returns and Allowances		7,000	
Net Sales			\$693,000
Less Cost of Goods Sold:			
Inventory January 1		\$ 36,000	
Purchases	\$400,000		
Add Freight	38,000	438,000	
Goods Available for Sale		\$474,000	
Inventory, December 31		40,000	
Cost of Goods Sold			434,000
Gross Profit on Sales			\$259,000
Less Selling and Administrative Expenses:			
Salesmen's Salaries		\$ 52,000	
Delivery Expense		18,000	
Advertising		25,000	
General Expense		60,000	
Insurance		1,600	
Heat and Light		22,000	
Donations		1,000	
Depreciation		25,000	204,600
Net Operating Profit			\$ 54,400
Add Financial Income:			
Purchase Discounts		\$ 4,500	
Sinking Fund Income		400	
		\$ 4,900	
Less Bond Interest Expense		3,000	1,900
Net Profit for the Year			\$ 56,300

ILLUSTRATION 86

COMPANY A AND SUBSIDIARY COMPANIES B AND C
CONSOLIDATED BALANCE SHEET
December 31, 1932

Assets			
Current Assets:			
Cash		$388,360	
Cash in Transit		10,000	
Customers		222,000	
Notes Receivable	$ 65,000		
Less Discounted Notes	10,000	55,000	
Inventories	$138,000		
Reserve for Intercompany Profit	7,720	130,280	
Total Current Assets			$ 805,640
Fixed Assets:			
Fixtures and Equipment	$280,000		
Reserve for Intercompany Profit	3,200		
	$276,800		
Reserve for Depreciation	134,600	$142,200	
Buildings	$750,000		
Reserve for Depreciation	242,500	507,500	
Land		53,000	
Total Fixed Assets			702,700
Bond Sinking Fund			160,000
Deferred and Prepaid Items			
Prepaid Insurance		$ 9,700	
Organization Expenses		70,000	
Bond Discount		6,750	
Total			86,450
Goodwill			33,000
Total Assets			$1,787,790
Liabilities and Capital			
Current Liabilities:			
Accounts Payable		$140,000	
Notes Payable		72,500	
Accrued Bond Interest		8,750	
Total Current Liabilities			$221,250
Fixed Liabilities:			
Bonds Payable			390,000
Minority Interest: (See Schedule, Illustration 89)			110,418
Net Worth:			
Capital Stock		$500,000	
Surplus*		566,122	
Total Net Worth			1,066,122
Total Liabilities and Capital			$1,787,790

*NOTE.—Including the consolidation's interest in appropriated surplus on the books of the individual companies for:

Sinking Fund Reserves	$160,000
Contingency Reserves	40,000
	$200,000

ILLUSTRATION 88

est in Company B should be regarded as realized. The procedure may be altered as follows:

Profit in Inventory of Company A:			
Earned by Company B	$2,500		
80% of same			$2,000
Earned by Company C	$3,000		
40% of same		$1,200	
80% of 60% of same		1,440	2,640
Profit in Inventory of Company B:			
Earned by Company C	$3,500		
80% of 60% of same		$1,680	
40% of same		1,400	3,080
Total			$7,720

K Intercompany profit on sale of fixtures. A reserve equal to the holding company's share (80% of $4,000 or $3,200) should be set up. As is indicated in Art. 20, depreciation expense should be computed on cost price to the consolidation. Cost price properly includes the minority interest's share of the profit. Depreciation expense as recorded in entry C above is apparently overstated by 12½ per cent. of $3,200, or $400. This is corrected by the adjustment *M*.

M Adjust depreciation expense.

SCHEDULE OF MINORITY INTEREST

Capital Stock of Company B, 20%		$ 60,000
Surplus of Company B, 20%		15,000
Reserve for Contingencies of Company B, 20%		2,000
Net Profit of Company B, 20%		30,682
Increase in Net Worth of Company C, 12%		
Capital Stock	$200,000	
Surplus	6,500	
Sinking Fund Reserve	10,000	
Net Profit	56,300	
Total	$272,800	
Sixty per cent. of Same	$163,680	
Less Net Worth Purchased	150,000	
Increase	$ 13,680	
Twenty per cent. of same		2,736
Total		$110,418

ILLUSTRATION 89

Explanation of Eliminations:

a, b, c, d, e—Book value acquired at the several dates of acquisition of stocks owned.

f Bonds owned—bonds payable.

g Intercompany sales and purchases.
h Intercompany accounts receivable and payable.
i Intercompany notes receivable discounted outside the consolidation.
j Intercompany advances.
k Intercompany interest income and expense.
m Intercompany accrued interest receivable and payable.

COMPANY A AND SUBSIDIARY COMPANIES B AND C
CONSOLIDATED STATEMENT OF PROFIT AND LOSS
Year Ended December 31, 1932

Gross Sales		$1,950,000	
Less Returns and Allowances		25,500	
Net Sales			$1,924,500
Less Cost of Goods Sold:			
Inventories, January 1		$ 140,224	
Purchases	$790,000		
Add Freight In	60,000	850,000	
Goods Available for Sale		$ 990,224	
Inventories, December 31		130,280	
Cost of Goods Sold			859,944
Gross Margin			$1,064,556
Less Selling and Administrative Expenses:			
Salesmen's Salaries		$ 202,000	
Delivery Expense		53,000	
Advertising		120,000	
General Expense		215,000	
Rent		40,000	
Heat and Light		72,000	
Donations		3,200	
Insurance Expense		4,100	
Depreciation		72,100	
Total			781,400
Net Operating Profit			$ 283,156
Add Other Income:			
Purchase Discounts		$ 12,700	
Interest Income		2,810	
Sinking Fund Income		4,900	20,410
			$ 303,566
Deduct Other Expense:			
Bond Interest			21,150
Net Profit for the Year			$ 282,416
Minority Interest in Company B			37,438
Holding Company's Share			$ 244,978

ILLUSTRATION 90

Minority Interest, Alternative Treatment.—There are those who will disagree with the author's computation of the minority interest, Illustration 89. It may be pointed out that there is no minority group in Company C and that the equity of the minority interest in Company B must be determined *solely from the records of that company.* While this is strictly true in a legal sense, it should not be overlooked that the consolidation cannot benefit from the earnings of Company C without a pro rata benefit to the minority interest in Company B. If Company A owned 100 per cent. of Company C, the minority interest in Company B would be limited to the net worth of Company B. It is true, too, that at the date of these statements, Company B has not recognized a certain increase in the value of its investment in

COMPANY A AND SUBSIDIARY COMPANIES B AND C
CONSOLIDATED COST OF GOODS SOLD WORKING PAPERS
Year Ended December 31, 1932

	Company A	Company B	Company C	Adjustments		Eliminations	Totals
Inventories, January 1	48,000	60,000	36,000	. .	3,776*I*	. . .	140,224
Purchases	450,000	540,000	400,000	. .	. .	600,000*g*	790,000
Freight Inward	22,000	. . .	38,000	. .	. .	. . .	60,000
Goods Available	520,000	600,000	474,000	. .	. .	. .	990,224
Inventories, December 31	43,000	55,000	40,000	7,720*J*	. .	. . .	130,280
Cost of Goods Sold	477,000	545,000	434,000	. .	. .	. .	859,944

NOTE.—Adjustments and Eliminations.
I—See Consolidated Surplus Working Papers, Illustration 92, for charge against surplus January 1.
J—See Consolidated Balance Sheet, Illustration 88, for Reserve for Intercompany Profit.
g—See Consolidated Profit and Loss Working Papers, Illustration 93.

ILLUSTRATION 91

Company C and that one might contend that the minority should not be credited with a share of such an unrecognized increase. In spite of such contentions, it is the author's opinion that failure to accord to the minority interest such share *as it must receive* if and when Company B recognizes the increase, results in an unpardonable overstatement of the consolidated surplus.

Alternative Working Papers.—As has been indicated in connection with the earlier problems, consolidated statements may be prepared from either the trial balances or the financial statements of the subsidiary companies. In either case, consolidated working papers are first prepared. Illustration 87 exhibits trial balance working papers. In Illustrations 91, 92, and 93 are given the working papers in the alternative form. Only the working papers showing the revenue accounts (Consolidated Cost of Goods Sold Working Papers, Illustration 91, Consolidated Surplus Working Papers, Illustration 92, Consolidated Profit and Loss Working Papers, Illustration 93) are given. The remaining accounts (assets, liabilities valuation reserves, and net worth other than surplus) would be handled as in the working papers prepared from the trial balances of the three companies. For this reason they are not repeated here.

COMPANY A AND SUBSIDIARY COMPANIES B AND C

Consolidated Surplus Working Papers

Year Ended December 31, 1932

	Company A	Company B	Company C	Adjustments Dr.	Adjustments Cr.	Eliminate	Company B Minority	Surplus	Company C Minority
Balances, January 1, 1932									
Company A	350,000								
Reserve Intercompany Profit in Inventories				3,776*l*					
Adjusted Balance								346,224	
Company B		135,000							
Eliminate 80% $80,000 Acquired						64,000*b*			
Minority Interest 20% $135,000							27,000		
Consolidate 80% $55,000 Increase								44,000	
Company C			46,000						
Eliminate 60% $50,000 Acquired						30,000*e*			
Minority Interest 12% $46,000							5,520		
Minority Interest 40% $46,000									18,400
Consolidate 48% $4,000 Decrease								1,920*	
Surplus Acquired for Minority Co. B								6,000*	
Duplicated in Elimination (*d*)							6,000*	6,000	
Net Profits for 1932	121,850	153,410	56,300						
Minority Interest:									
20% $153,410							30,682		
12% $56,300							6,756		
Holding Company's Share								244,978	
Totals	471,850	288,410	102,300				63,958	633,282	18,400

	Company A	Company B	Company C	Adjustments Dr.	Adjustments Cr.	Eliminate	Company B Minority	Surplus	Company C Minority
Deductions:									
Dividends Paid	50,000	45,000	16,000			45,600*H*	9,000	50,000	6,400
Organization Expense Amortized		5,000					1,000	4,000	
Loss of Capital Assets			13,500				1,620	11,880	
Total Deductions	50,000	50,000	29,500				11,620	65,880	6,400
Balances, December 31, 1932	421,850	238,410	72,800				52,338	567,402	12,000
Adjustments:									
Surplus Attending Stock Transfer July 1								12,000	12,000*
								579,402	
Eliminate Surplus Acquired 40% $30,000						12,000*d*		12,000*	
Adjustment for duplication resulting from Company B's reporting as income, dividends received from Company C, 12% $16,000							1,920*	1,920	
Minority Interest in Surplus							50,418		
Reserve for Intercompany Profit in Equipment								569,322	
								3,200	
Consolidated Surplus, December 31, 1932								566,122	

*Negative amount.

For descriptions of adjustments and eliminations, see explanations of these items accompanying the first form of working papers, pages 136-140.

Illustration 92

COMPANY A AND SUBSIDIARY COMPANIES B AND C
CONSOLIDATED PROFIT AND LOSS WORKING PAPERS
Year Ended December 31, 1932

	Company A	Company B	Company C	Eliminations	Total
Gross Sales	900,000	950,000	700,000	600,000g	1,950,000
Less Returns	8,500	10,000	7,000	. . .	25,500
Net Sales	891,500	940,000	693,000	. . .	1,924,500
Less Cost of Goods Sold	477,000	545,000	434,000	. . .	859,944
Gross Profit on Sales	414,500	395,000	259,000	. . .	1,064,556
Less Selling Expenses	175,000	105,000	95,000	. . .	375,000
Trading Profit	239,500	290,000	164,000	. . .	689,556
Less General Expenses	150,100	147,100	109,600	400M	406,400
Operating Profit	89,400	142,900	54,400	. . .	283,156
Add Other Income:					
Purchase Discounts	2,200	6,000	4,500	. . .	12,700
Interest Income	2,500	310	. . .	. . .	2,810
Bond Interest Income	3,000	600	. . .	3,600k	. . .
Dividends	36,000	9,600	. . .	45,600H	. . .
Sinking Fund Income	4,500	. .	400	. .	4,900
	137,600	159,410	59,300		303,566
Less Other Expenses:					
Bond Interest	15,750	6,000	3,000	3,600k	21,150
Net Profit for 1932	121,850	153,410	56,300	. . .	282,416
Minority Interest:					
Company B, 20%	. . .	30,682	. . .	. . .	. . .
Company C, 12%	. . .	. .	6,756	. . .	37,438
Holding Company's Share	121,850	122,728	49,544	(49,144)	244,978

NOTE.—For description of adjustments and eliminations see explanation of these items accompanying the first form of working papers, pages 136-140.

ILLUSTRATION 93

The surplus of Company C on January 1, 1932, may be found as follows:

COMPANY C
ANALYSIS OF SURPLUS

Balance per Trial Balance December 31:		
Reserve for Sinking Fund	$10,000	
Earned Surplus	6,500	
Total		$16,500
Loss (Assumed to be loss of capital assets)		13,500
Balance, June 30 (Stated in problem)		$30,000
Add Dividends Declared June 20		16,000
Balance January 1, 1932		$46,000

The problem indicates that Company C's sinking fund requirement is due annually on May 1. It is likely that the Reserve for Sinking Fund is increased concurrently. The $46,000 balance shown was apparently carried on January 1, as Surplus $38,500 and Reserve for Sinking Fund $7,500. The appropriating on May 1 of $2,500 to the Reserve for Sinking Fund did not alter the company's total surplus and is, accordingly, omitted from the foregoing analysis.

Dividends Paid by Company C: The problem indicates that Company C paid out $16,000 in dividends, declared June 20 and paid July 5. These were payable to stockholders of record June 20. Accordingly, in the consolidated surplus working papers, Illustration 92, the minority interest is charged with $15,400 in dividends (20% of $45,000 paid by Company B plus 40% of $16,000 paid by Company C).

PROBLEMS

Solutions to the following problems are now to be prepared by you after careful study of the foregoing chapter. Any good quality paper on which your work will appear neat and legible may be used.

Problem 1.—Following are the trial balances of Companies A, B, and C at December 31, 1934:

	A	B	C
Debits			
Cash	162,030	75,820	101,640
Accounts Receivable	125,640	120,400	124,208
Notes Receivable	50,000		
Raw Material, January 1	41,285	32,648	45,614
Purchased Raw Material	295,850	213,380	270,690
Labor	225,610	175,819	195,713
Manufacturing Burden	218,450	164,372	168,440
Process Inventory, January 1	61,375	47,610	54,709
Finished Goods, January 1	40,650	33,819	47,480
Selling Expenses	98,480	75,210	92,214
General Expenses	72,350	39,394	54,582
Plant and Equipment	842,000	625,000	650,090
Investments:			
Stock Company B	560,000		
Stock Company C	750,000		
Bond Sinking Fund	30,000		
Discount on Bonds	22,500		
Dividends Receivable			
Bond Interest (6 months)	15,000		
	3,611,220	1,603,472	1,805,380
Credits			
Capital Stock	1,500,000	400,000	500,000
Notes Payable	60,000	50,000	
Accounts Payable	54,785	42,610	61,815
First Mortgage Bonds	500,000		
Sinking Fund Reserve	30,000		
Depreciation on Assets	277,585	175,000	215,600
Sales (Net)	1,031,235	735,862	852,965
Surplus, January 1	157,615	200,000	175,000
	3,611,220	1,603,472	1,805,380

Company A owns 80 per cent. of the capital stock of Company B. At the time of acquisition, the capital stock of Company B was $400,000 and the surplus was $150,000.

All of the $500,000 capital stock of Company C was acquired at a cost of $750,000. The surplus of Company C at date of acquisition of the stock was $133,000.

The First Mortgage Bonds of Company A were dated January 2, 1932, and made payable twenty years thereafter. Interest thereon at 6 per cent. is payable semiannually. These bonds were sold at 95 per cent. of face value.

No debits or credits were made to Surplus during the current year.

Interest on bonds is to be set up and a reserve of $15,000 for sinking fund is to be provided. Discount on bonds is to be amortized one-twentieth yearly.

Accruals (other than interest on bonds) and deferred items are not to be considered in this problem.

Inventories at December 31, 1934, were as follows:

	A	B	C
Raw Materials	50,790	36,292	51,478
Goods in Process	68,915	51,816	60,834
Finished Goods	48,210	38,782	54,615
	167,915	126,890	166,927

Inventories of Companies B and C include purchases from Company A on which the latter company made a profit. The profit included in B's inventory was estimated at $5,000 and in C's inventory at $6,000.

At the close of the year 1934, dividends on capital stock were declared by the several companies as follows: Company A, 10 per cent.; Company B, 10 per cent.; Company C, 15 per cent. All dividends were payable on January 15, 1935. No capital stock was issued during the year 1934.

From the given data, prepare for the current year a consolidated profit and loss statement, a consolidated surplus statement; and a consolidated balance sheet, showing goodwill; also a schedule of the minority interest. Intercompany expense and income accounts should not be eliminated, because data are incomplete. Unless elimination can be made accurately, no purpose is served by the elimination.

Problem 2.—On December 31, 1933, the consolidated working papers of Companies D, E, and F exhibited a reserve for intercompany profits in inventories of $2,000. The books of the respective companies give the following information:

	D	E	F
Surplus, January 1, 1934	180,000	120,000	90,000
Dividends Paid, 1934	60,000	30,000	80,000
Profits, 1934	97,000	90,000	100,000
Capital Stock	500,000	200,000	200,000

Company D owns 60 per cent. of Company E's stock and 80 per cent. of Company F's stock. These stocks were bought June 30, 1930, for $200,000 and $180,000, respectively, when the net worth accounts were:

	E	F
Capital Stock	200,000	200,000
Surplus	100,000	50,000

The consolidated profit and loss working papers at December 31, 1934, indicate that the holding corporation's share of the net profit for the year ended on that date is $97,000.

The December 31 inventory of Company D contains goods on which Company E made a profit of $3,000 and goods on which Company F made a profit of $2,000. The inventory of Company F contains goods on which Company D made a profit of $1,500.

Company D has followed the practice of taking up its share of the profits or losses of its subsidiary companies.

You are asked to submit:

(1) A transcript of the investment accounts from January 1 to December 31, 1934.

(2) A schedule of minority interests.

(3) Consolidated surplus working papers for the year ended December 31, 1934.

Retain your solutions and continue with the study of the next chapter.

CHAPTER VI

CORPORATE REORGANIZATIONS

34. General Considerations.—It is not unusual for a corporation to find itself at a point beyond which it is unable to continue ordinary operations under existing conditions. The reasons for the corporation's being at this point may be few or many, definite or indefinite. Two closely related reasons are ignorance and dishonesty. It is not asserted that the two terms are synomymous but the results produced by one may be identical with the results produced by the other. The company that has lost its assets through embezzlement is in a position similar to that of the company which has lost its assets because the officers of the company ignorantly continued to sell the company's products below cost of production. It is human to err and if a number of serious errors are, through a combination of unfortunate circumstances, committed within a limited time, the corporation may find that it is on the verge of bankruptcy as a result. Rapid and violent changes in economic conditions may of themselves bring a corporation to the point where it faces the alternatives of bankruptcy or reorganization. It is not the purpose of this chapter to deal extensively with the various factors that result in such misfortunes to the corporate enterprise. Rather we are concerned with the results produced by these factors. For the accountant, the situation exists. He is interested in the causes only in so far as they may be avoided or counteracted in the future.

When a corporation reaches a point beyond which it cannot continue operations without drastic changes, it faces the alternatives of bankruptcy or reorganization. For many corporations, a reorganization likely to produce satisfactory results will be out of the question. If, for example, a corporation is equipped to manufacture only one highly specialized product and the public has almost entirely ceased demanding this product, little, if any, reason exists for attempting to continue the business. It represents, simply, capital that has been lost in an unsuccessful venture. Its capital is worthless because it is in a form for which there is no demand. As a second example, one may think of a corporation that has been engaged in a highly competitive field like the retail grocery field. If it has lost its capital through an unprogressive attitude, through the increasing unpopularity of disgruntled officers and employes, or through the public's loss of confidence in the integrity of the management, it is not likely that even drastic reorganization will be of much benefit. There are so many other stores catering to the public that it would be almost impossible for such a corporation to regain lost prestige in sufficient amount to warrant the risks that inevitably attend going on.

For other corporations, reorganization may be the proper alternative. A corporation may be unable to meet its current financial obligations because of the failure of certain customers to pay promptly the amounts owed to the corporation.

In other words, large bad-debt losses coming unexpectedly or with almost no warning may embarrass a corporation otherwise sound. If the officers and directors of a corporation have been overly optimistic in viewing the future progress of the business undertaking, they may have expanded plant facilities more rapidly than actual conditions warrant. If this expansion has been financed by means of a bond issue, the corporation, with income far below that anticipated, may find itself unable to meet its periodic interest charges.

When a corporation is unable to meet its obligations, it may seek voluntary bankruptcy or its creditors may petition it into involuntary bankruptcy. In either event it is likely that the unsecured creditors will receive almost nothing when their claims are liquidated. Figures published not long ago revealed the startling fact that the average payment to unsecured creditors in bankruptcy actions in the United States has been, over a period of several years, less than ten cents on the dollar. Any alternative which gives promise of even slightly greater returns is likely to prove attractive to creditors. Some compromise may be effected under which the creditors agree to scale down their claims. A receiver may be appointed, by order of a court, to operate the business for the benefit of the creditors. The company may undergo a general reorganization. The last of these possibilities forms the subject of this chapter.

Reorganization is undertaken when it seems to be the best means of protecting *all of the equities.* One might expect to find the secured creditors almost wholly uninterested in the welfare of the unsecured creditors and interested not at all in the ownership equity. It is true that the secured creditors may take their security and give no thought to the welfare of the other equities. But security is frequently worth far less at forced sale value than the face of the debt that it presumably secures. As an integral part of a going concern, a building, a machine or a patent, may be very valuable. Apart from the other units of the organization, no one of these may be particularly valuable. In the hands of expert management, they may be made highly productive, while at forced sale they may bring little or nothing. Early in 1933, for example, a business whose balance sheet in 1930 showed assets of over $40,000,000 was sold at auction for slightly more than $500,000. If the ownership equity is disregarded, the creditors are quite likely to be without the services that only those thoroughly familiar with the organization can be expected to render. For these reasons, and many others, it is frequently the part of wisdom for each class of equity to surrender some part of its claim for the benefit of all.

35. Plan of Reorganization.—Some plan for reviving and continuing the corporation must be adopted. This should be prepared by a committee whose work and recommendations are likely to receive the endorsement of a majority of the creditors and owners. Every effort should be put forth to avoid the total sacrifice of the interests of one group for the benefit of any other or others. If the plan disproportionately favors the secured creditors, it is unlikely to receive the support of the unsecured creditors and owners. The owners are not likely to be interested in any plan which does not give them a fair chance to regain full control of their

business as a going concern. It is safe to assert that *the selecting of the right committee is the most significant step in the entire program.*

In order to warrant a reorganization there must be reason to believe that the corporation *after reorganization* has a good chance to continue operations at a profit. Reorganization is seldom worth while if it will result in little more than a postponing of the day of final reckoning. Several means may be available to aid the corporation:

1. It may be possible to introduce new capital, the proceeds of which can be used to liquidate the more pressing claims of creditors.

2. It may be possible to effect a composition with the creditors under which agreement each creditor voluntarily transfers a part of his claim into a long-term debt at a low interest rate or surrenders some part of his claim entirely. For example, it may be agreed that each $1,000 of debt now due shall be payable:

> $200 on demand,
> $200 after one year from date but subject to renewal for a like period if the corporation so requests,
> $400 five years after date, such part to be evidenced by notes bearing 5 per cent. interest annually,
> $200 canceled.

3. It may be possible to effect a transfer of equities from liability status to capital status. The creditors, for example, may be willing to accept preferred stock or even common stock for part or all of their claims. Usually stock acceptable to the creditors must enjoy some preference over that in the hands of the ownership group. The preference may be brought about by issuing common stock to both creditors and owners but on a basis which provides a higher ratio for the creditors. To illustrate: Creditors' claims of $200,000 and owners' claims of $300,000 ($100,000 preferred stock and $200,000 common stock) may exist at the time the corporation is unable to continue. The corporation might be reorganized on the following basis:

> Creditors: $200,000 6 per cent. Cumulative First Preferred Stock,
> Preferred Stockholders: $50,000 6 per cent. Non-cumulative Second Preferred Stock and $25,000 Common Stock,
> Common Stockholders: $100,000 Common Stock.

The foregoing might be reflected by the following journal entry:

Creditors' Claim (Itemized)	200,000	
Preferred Stock	100,000	
Common Stock	200,000	
First Preferred Stock		200,000
Second Preferred Stock		50,000
Common Stock		125,000
Donated Surplus		125,000

To record exchange of securities as indicated.

Or a second basis for reorganization might be:

Creditors: $200,000 Common Stock.
Preferred Stockholders: $50,000 Common Stock.
Common Stockholders: $50,000 Common Stock.

It should be evident that in converting liabilities to net worth the number of possible combinations is almost without limit.

4. If the creditors will not accept an ownership claim in exchange for their present claims, it may be possible to effect a transfer from one type of liability to another. This is not unlike the composition with creditors already mentioned. The holders of 6-per-cent. First Mortgage Bonds may accept 6 per cent. First Mortgage Income Bonds. The company is thus benefited not by a reduction in the amount of outstanding debt but by the provision under which it need not pay interest on its bonds unless the interest requirement is earned. Such income bonds may be either cumulative or non-cumulative. The holders of Second Mortgage Bonds may accept debenture bonds or other junior liens. Holders of both First and Second Mortgage Bonds may exchange their holdings for debentures on some equitable basis in order that the corporation may secure additional funds through the issuing of new First Mortgage Bonds.

COMPANY A
BALANCE SHEET
December 31, 1934

Assets		*Liabilities and Capital*		
Cash	$ 100,000	Notes to Banks		$200,000
Receivables (Net)	200,000	Accounts Payable		500,000
Inventories	300,000	Accrued Bond Interest		60,000
Plant and Equipment (Net)	1,500,000	Bonds Payable		500,000
Bond Discount	25,000	Capital:		
Treasury Stock, Common	75,000	1st Preferred Stock	$ 500,000	
Goodwill	150,000	2nd Preferred Stock	300,000	
		Common Stock	500,000	
		Total	$1,300,000	
		Capital Surplus	100,000	
		Total	$1,400,000	
		Less Deficit	310,000	
		Net Worth		1,090,000
	$2,350,000			$2,350,000

ILLUSTRATION 94

The actual recording of the reorganization calls for the application of no new principles. As is indicated in the illustrative entry in paragraph 3, the old claims (of either creditors or owners or both) are written off and in their stead new claims are set up. If an operating deficit appears on the books, any surplus resulting from the reorganization is applied first toward the eliminating of this deficit. Any discount or premium on old stock or bond issues should be closed out to the surplus (or deficit) account. This is true, likewise, of any unissued stock, treasury stock, or treasury bonds of issues to be discontinued. If a goodwill account appears, its balance is usually closed out. The balance sheet shown in Illustration 94, and additional data, may be used to illustrate the journal entries involved in a reorganization:

Additional Data:

1. The bonds are first mortgage bonds bearing 6 per cent. per annum. One-half of the issue matures January 1, 1935.

2. The notes issued to banks mature March 1, 1935. They have been renewed frequently and the bankers have indicated that no further renewals will be granted.

3. The first preferred stock is 7-per-cent. cumulative. No dividends have been paid on this stock since January 1, 1930. At that time, there were no dividends in arrears.

4. The second preferred stock is 6-per-cent. cumulative. Dividends in arrears amount to $63,000.

5. The treasury stock account represents 1,000 shares of stock having a par value of $100 per share.

A committee representing the bondholders, bankers, other creditors, and stockholders, has prepared a plan under which a reorganization may be undertaken. The committee is of the opinion that the corporation's financial difficulties are due primarily to overexpansion of plant and equipment and that the management otherwise has been honest and efficient. The committee believes that the company should earn satisfactory profits if, through the reorganization proposed, the indebtedness can be scaled down, certain economies effected in operations, and depreciation charges reduced through a reduction of the plant account. The detailed proposal follows:

1. Accounts payable shall be compromised at 80 cents on the dollar, and this compromised amount shall be payable 40 cents on demand and 40 cents one year after date. This deferred amount shall be represented by notes payable bearing 4-per-cent. interest per annum.

2. Notes payable to banks shall be extended for a period of two years and the bankers shall advance further loans of $200,000 repayable one-half at the end of six months and the balance at the end of one year. It is further agreed that these new loans shall be regarded in liquidation as enjoying priority over the old loans and the claims of ordinary creditors at December 31, 1932.

3. A new issue of 6-per-cent. first mortgage bonds in the amount of $500,000 is authorized. An issue of $250,000 of 6-per-cent. cumulative debenture income bonds is authorized. The outstanding first mortgage bonds shall be exchanged for the entire issue of debentures plus one-half of the new first mortgage bonds. The balance of the new first mortgage bonds shall be sold to the bankers at 92.

4. A new issue of $300,000 7-per-cent. cumulative first preferred stock shall be sold at par.

5. The first preferred stock now outstanding and all attending claims for dividends in arrears shall be exchanged for a $400,000 issue of 6-per-cent. cumulative second preferred stock.

6. There is authorized a $500,000 issue of Class A common stock consisting of 5,000 shares of a par value of $100 each. The second preferred stock now outstanding and all attending claims for dividends in arrears shall be exchanged for Class A common stock of a par value equivalent to such total claims. Class A common stock shall receive non-cumulative dividends of 6 per cent. per annum before any dividends shall be paid on Class B common stock. After a dividend of $2.00 per share shall have been paid in any one year on Class B common stock, Class A common stock shall participate in further dividends at the rate of fifty cents ($.50) per share for each additional one dollar ($1.00) per share paid to the Class B common stock.

7. There is authorized 20,000 shares of Class B common stock without par value but having a stated value of five dollars ($5.00) per share. The 4,000 shares of common stock now outstanding shall be exchanged for 12,000 shares of Class B common stock.

8. The plant account shall be written down $500,000 in order to secure a reduction in the company's annual provision for depreciation of plant and equipment.

If the proposal is accepted by all the parties interested and its terms are carried out, the reorganization may be recorded by the following journal entries:

Accounts Payable	$500,000	
Accounts Payable		$200,000
Notes Payable, Special		200,000
Surplus		100,000
To record compromise with creditors.		
Notes to Banks	200,000	
Notes Payable, Special		200,000
To record renewal of notes for a two-year period.		
Cash	200,000	
Notes Payable to Banks		200,000
To record additional advances by bankers.		
Unissued First Mortgage Bonds	500,000	
Unissued Income Bonds	250,000	
First Mortgage 6% Bonds		500,000
Income Debenture Bonds		250,000
To record bond authorizations.		
Bonds Payable	500,000	
Surplus	25,000	
Unissued First Mortgage Bonds		250,000
Unissued Income Bonds		250,000
Bond Discount		25,000
To record exchange of bonds and to write off unamortized discount on the old bonds.		

Cash	$230,000	
Bond Discount and Expense	20,000	
Unissued First Mortgage Bonds		$250,000
To record sale of one-half of bonds at 92.		
Cash	300,000	
First Preferred Stock, 7% Cumulative		300,000
To record sale of stock at par.		
First Preferred Stock	500,000	
Second Preferred Stock, 6% Cumulative		400,000
Surplus		100,000
To record exchange of stock.		
Unissued Common Stock, Class A	500,000	
Common Stock, Class A		500,000
To record stock authorization.		
Second Preferred Stock	300,000	
Surplus	63,000	
Unissued Common Stock, Class A		363,000
To record exchange of stock.		
(The Corporation has been authorized to issue 20,000 shares of Class B Common Stock without Par Value but with Stated Value of $5 per share.)		
Common Stock	500,000	
Common Stock, Class B		60,000
Treasury Stock, Common		75,000
Surplus		365,000
To record exchange of 4,000 shares of common stock of $100 par value per share for 12,000 shares of common stock without par value and to close out 1,000 shares of common stock held in the treasury		
Accounts Payable	200,000	
Accrued Bond Interest	60,000	
Cash		260,000
To record payment of account balances payable on demand and of accrued interest on bonds.		
Surplus	500,000	
Plant and Equipment		500,000
To write down this asset.		
Surplus	150,000	
Goodwill		150,000
To write off goodwill.		

NOTE.—The writing off of the goodwill is not essential. It is obvious that the corporation has not earned anything that might be regarded as "excess profits," but it does not follow that the goodwill should be amortized for this reason alone. The writing down of the plant account produces a deficit and this deficit is only increased by the closing of the goodwill account. This is, however, not entirely without purpose. The corporation cannot distribute any earnings as dividends until after profits equal to the amount of the deficit have been applied to raising the capital to its stated value.

The balance sheet of the reorganized corporation may be, and usually is, prepared prior to the acceptance of the reorganization proposal. It is used as a picture of the financial position which will probably result if the plan is carried out as contemplated by the committee. Such balance sheets should leave in the readers' minds no doubt that they are based in large measure on a projection into the future rather than wholly on transactions of the past. The balance sheet of Company A as reorganized may appear as in Illustration 95:

COMPANY A

BALANCE SHEET

December 31, 1934

(After giving effect to the reorganization proposed by Messrs. Doe, Roe, and Koe.)

Assets			
Current Assets:			
Cash		$ 570,000	
Receivables (Net)		200,000	
Inventories		300,000	
Total Current Assets			$1,070,000
Fixed Assets:			
Plant and Equipment (Net)			1,000,000
Deferred Charges:			
Discount on Bonds			20,000
Total Assets			$2,090,000
Liabilities and Capital			
Current Liabilities:			
Notes Payable to Banks		$ 200,000	
Notes Payable, Special		200,000	
Total Current Liabilities			$ 400,000
Fixed Liabilities:			
Notes Payable, Special		$ 200,000	
First Mortgage Bonds Payable		500,000	
Income Debenture Bonds Payable		250,000	
Total Fixed Liabilities			950,000
Capital:			
First Preferred Stock, 7% Cumulative		$ 300,000	
Second Preferred Stock, 6% Cumulative		400,000	
Common Stock, Class A	$500,000		
Less Unissued Stock	137,000	363,000	
Common Stock, Class B (Without Par Value, 12,000 Shares)		60,000	
Total Capital Stock Outstanding		$1,123,000	
Deduct Deficit		383,000	
Net Worth			740,000
Total Liabilities and Net Worth			$2,090,000

ILLUSTRATION 95

It is not essential that the balance sheet be prepared as of December 31, 1934. The statement of the problem indicates that the committee has been active because it has been evident for some time that the corporation could not continue. Hence, it is proper to prepare a balance sheet as it would appear if the committee's plan were adopted in order that this statement may be compared with the one reflecting actual conditions on the date in question. Frequently the committee estimates the time that will be required for carrying out its scheme, and prepares estimates of income and expenses for the period, also receipts and disbursements, and other items of significance, and finally the financial statements at the end of the period in question.

36. Principal Work of the Accountant.—The foregoing illustration gives evidence of the truth of the statement that the preparing of the actual reorganization entries is not difficult. These entries are the summation of various tasks far more difficult. The principal work of the accountant may be outlined as follows:

1. Analyzing of the financial statements of two or more past periods, and studying of market reports, production schedules, selling terms, and other significant facts in an attempt to determine the exact causes of the existing financial stringency.

2. Recasting of the financial statements of two or more past periods in order to indicate the financial conditions that would exist if the proposed plan of reorganization had been in operation two or three periods earlier. In connection with these statements, there must be considered:

(*a*) Changes in Fixed Charges: These include any changes in depreciation and/or depletion schedules, interest on old and new securities, etc.

(*b*) Expenses of Activities to be Abandoned or Discontinued: The reorganization proposal may contemplate the abandoning of a warehouse, of land held as a possible plant site, the discontinuing of a given line of product or of certain branch houses or agencies or of other things now a part of the corporation's regular activities. The abandoning of these activities will, of course, eliminate the expenses attending them.

(*c*) Expense of Activities to be Introduced: In addition to, or instead of, abandoning certain activities, the plan may call for the introduction of new activities. The corporation may plan to establish its own branches instead of relying on local independent wholesalers or retailers as has been done in the past. It may decide to establish its own factory for performing certain processes that previously have been performed by others. Any expenses attending such changes must be regarded as expenditures that were not present before.

(*d*) Non-recurring Expenses and Losses: Full consideration must be given to the effect of certain losses and expenses of the past if these may be properly regarded as non-recurring in nature. It may be that the company has been under heavy financial obligations because of accidents, judgments, fire losses, or for special items such as expenses attending a period of unusually heavy construction or attending the moving of a plant or the relocating of machinery.

(*e*) Excessive Expense in Usual Items: Such items as salaries and office expenses are regular and recurring. It is possible, however, that much of the corporation's difficulty may be traced to the fact that excessive salaries and/or bonuses have been paid to certain officers, attorneys, or others.

(*f*) Income Items: The accountant must take into consideration the effect of the proposed changes on the income of the corporation. He must eliminate from the recast statements all income derived from activities to be abandoned under the new plan of operation. If a building occupying a possible plant site has been rented but is now to be abandoned, the accountant must not overlook the decrease in income that will result. He must, of course, consider the probable income to be derived from any new lines or activities that are to be introduced.

It is not likely that the accountant in any one case will find all of the factors that have been mentioned to be of consequence. On the other hand, it is true that a given case may bring forth some item not mentioned in this brief survey. The accountant must be alert to the demands of the work in hand and in the preparing of statements that are reliable and complete. He should be alert, too, in the matter of discovering actual accounting errors of the past. He should introduce into his work correcting or adjusting entries for items improperly charged to surplus, profit and loss, to assets, or to liabilities. Likewise, the credits to these accounts should be altered if they have not been made in accordance with accepted accounting principles.

His statements should reflect any policy changes that are contemplated by the proposed reorganization plan. These may center around bad debts, depreciation allowances, instalment sales, uncompleted contracts, the paying of departmental salaries or bonuses, or any other items within the range of the corporation's activities. If the corporation chances to be a holding corporation, definite policy changes may be contemplated in the manner in which the corporation has dealt with its subsidiaries. Not least important of these may be the matter of changing the method of handling income from subsidiaries from a dividends-received or "carrying-at-cost" basis to an income-earned or "carrying-at-present-value" basis.

QUESTIONS AND PROBLEMS

Answers and solutions to the following questions and problems are now to be prepared by you after careful study of the foregoing chapter. Any good quality of paper on which your work will appear neat and legible may be used.

(1) Name several factors which indicate that a corporation should not be reorganized but should be liquidated.

(2) Outline the principal work of the accountant in connection with the reorganizing of a corporation?

(3) What is the purpose of preparing a balance sheet "after giving effect to refinancing"?

(4) **Problem.**—At a meeting of the stockholders of the Johnson Manufacturing Company, held on June 10, 1934, the officers of the company were authorized to put into effect the following plan of refinancing:

1. An issue of \$2,000,000 First mortgage 6-per-cent. Gold Bonds maturing July 1, 1949, is to be sold to bankers at $92\frac{1}{2}$, and the present First Mortgage 7-per-cent. Gold Bonds, of which \$250,000 are outstanding, are to be called at 105.
2. An issue of \$1,100,000 preferred stock, 7-per-cent. cumulative, par value \$100, is to be sold at par or exchanged and the present 8-per-cent. preferred stock, par value \$100, of which \$927,500 par value is outstanding, is to be retired.
3. A commission of \$2.50 will be paid to brokers on each share of the present outstanding preferred stock which they succeed in exchanging for new preferred stock, and a commission of \$6.00 per share will be paid on each of the remaining new shares sold. Commissions paid will be regarded as stock discount.
4. New shares of common stock, without par value (100,000 shares authorized) will be exchanged for the present \$100 par value common stock, of which there are 12,493 shares outstanding, in the ratio of eight new shares for one old share.
5. The loans and bills payable and the instalment mortgage are to be liquidated and the accounts payable are to be reduced by \$300,000.

You were engaged by the bankers to examine the accounts of the company for the five-year period ending June 30, 1934, and have found as follows:

(*a*) Trial Balance after closing, June 30, 1934:

Accounts Receivable	1,512,099.31	
Accounts Payable		593,570.81
Accrued Accounts		89,311.99
Bills Receivable	287,770.68	
Cash	195,998.66	
Cash Surrender Value of Insurance on Lives of Officers	60,738.57	
Common Stock, 12,493 Shares		1,249,300.00
First Mortgage 7-per-cent. Bonds, due 1938		250,000.00
Guaranteed Deposits	6,325.19	
Instalment Mortgage (On property not covered by Mortgage Indenture)		9,724.29
Loans and Bills Payable		1,362,000.00
Marketable Securities	27,713.24	
Plant and Equipment (Depreciated Value)	1,828,400.57	
Preferred Shares, 9,275 Shares		927,500.00
Prepaid Accounts	279,040.19	
Product Finished and In Process	928,361.21	
Reserve for Doubtful Accounts		29,000.00
Raw Materials and Supplies	492,169.59	
Railroad Claims	599.62	
Reserve for Federal Income Taxes		33,750.00
Surplus		1,092,077.20
Sinking Fund for Retirement of Preferred Stock	17.46	
Unamortized Bond Discount and Expense	17,000.00	
	5,636,234.29	5,636,234.29

(*b*) Interest on the old bond issue and all dividends on the preferred stock have been paid.

(*c*) All of the present holders of preferred stock have agreed to exchange their stock for stock of the new issue. $110 par value of new stock is to be given in exchange for $100 par value of old.

(*d*) The expenses to be incurred in connection with the proposed refinancing are estimated to be $15,000.

(*e*) The Ross Appraisal Company has appraised the value of the plant and equipment at cost to reproduce new less accrued depreciation, as of June 30, 1934, at $4,371,140.14.

(*f*) The net profits of the company for the five fiscal years ended June 30, were as follows:

Year ended June 30, 1930	$270,403.01
Year ended June 30, 1931	322,468.19
Year ended June 30, 1932	191,910.59
Year ended June 30, 1933	277,681.93
Year ended June 30, 1934	251,330.23

(*g*) The provision already made for Federal income taxes will be taken as correct.

(*h*) The balance of the Unamortized Bond Discount and Expense account will be regarded as applicable to the new issue of bonds.

(*i*) The inventories were found to be substantially correct as to quantities and priced at cost or market, whichever was lower, and the trial balance after closing was found to be correct.

Submit the following:

1. A certified balance sheet as of June 30, 1934, giving effect to the proposed refinancing. (Include in your certificate the results of operations for the period of your examination.)

2. The journal entries necessary to bring the books of account into agreement with the balance sheet after giving effect to the proposed refinancing.

Look over your answers and solutions to the questions and problems following Chapters V and VI and immediately send them to the Schools for correction.

Date Due

JAN 11 1949 1/65			
OCT 19 1950 11/2			

END OF
TITLE